

***United States Court of Appeals
for the Second Circuit***



**BRIEF FOR
APPELLEE**

76-7607

No. 76-7619

To be argued by
HOWARD BREINDEL

The
United States Court of Appeals
For The Second Circuit

UNIVERSITY HILL FOUNDATION,
Plaintiff-Appellee and Cross-Appellant,

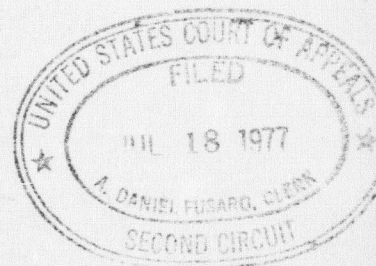
-against-

GOLDMAN, SACHS & CO.,
Defendant-Appellant and Cross-Appellee.

*Appeal from the United States District Court for the Southern
District of New York (71 CIV. 1166 (MEL)).*

**BRIEF FOR PLAINTIFF-APPELLEE AND CROSS-
APPELLANT UNIVERSITY HILL FOUNDATION**

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TABLE OF CONTENTS

	<u>Page</u>
State of Issues Presented For Review.....	1
A. By The Appeal Of Goldman, Sachs & Co. ("GS").....	1
B. By The Appeal Of The University Hill Foundation ("FOUNDATION").....	1
Statement Of The Case.....	2
Statement Of Facts.....	2
Summary Of Argument.....	8
A. The FOUNDATION'S Answer To The Arguments Raised By GS On Appeal.....	8
B. Arguments Raised By The FOUNDATION On Appeal.....	11
POINT I - As A Matter Of Law GS Repre- sented To The FOUNDATION That It Had Conducted An Adequate And Reasonable Credit Investi- gation Of Penn Central.....	13
POINT II - The District Court Properly Con- cluded That GS Did Not Conduct An Adequate And Reasonable Credit Investigation Of Penn Central After February 4, 1970 And There- fore Violated §12(2).....	18
A. The District Court Imposed A Proper Standard Of Invest- igation On GS.....	20
B. The District Court's Con- clusion That GS Did Not Conduct A Reasonable And Adequate Credit Investiga- tion Was Not Clearly Erroneous.....	30

POINT III-	The Causation Requirement Of §12(2) Was Satisfied.....	34
A.	Causation Pursuant To §12(2) Exists Between The Misrepresentation By GS And The FOUNDATION'S Damage.....	34
B.	If The FOUNDATION Has The Burden Of Showing That An Adequate Credit Investigation By GS Would Have Revealed Information That Would Be Significant To GS In Connection With GS' Opinion That Penn Central Was creditworthy, It Has Satisfised That Burden.....	41
1.	PX-101-103 Could Have Been Obtained From Penn Central.....	42
2.	PX-101-103 Were Properly Admitted In Evidence.....	43
(a)	PX-101-103 Were Properly Authenti- cated And In Any Event GS Waived Any Objection To Authenticity.....	44
(b)	PX-101-103 Are Business Records.....	45
(c)	Even If PX-101-103 Were Hearsay, They Nevertheless Estab- lish That Had GS Been Aware Of Their Contents, It Would Be Significant To GS In Connection With Its Opinion That Penn Central Was Creditworthy.....	50

C.	A Reasonable Credit Investigation Would Have Revealed To GS That Penn Central Lacked "Adequate Contingency Planning".....	51
D.	Nothing Would Have Caused GS To Change Its Unreasonable Opinion That Penn Central Was Creditworthy.....	52
POINT IV -	The District Court Erred In Concluding That GS Did Not Have A Duty To Disclose Material Facts.....	55
A.	GS Had A Duty To Disclose The Omitted Facts.....	55
B.	The Facts Which GS Failed To Disclose Were Material.....	63
1.	The Inventory Omissions...	65
2.	The Banklines Omission....	71
3.	The Brown Bros. Harriman & Co. Omission.....	82
POINT V -	The District Court Erred In Concluding That NCO's Prime Rating Of Penn Central Commercial Paper Was Not Based on GS' Decision To Continue Selling The Paper.....	84
Conclusion.....		92

TABLE OF AUTHORITIES

<u>CASES:</u>	<u>PAGE</u>
Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972).....	17, 39, 63, 64
Agrashell, Inc. v. Bernard Sirotta Co., 344 F. 2d 583 (2d Cir. 1965).....	90
Berko v. SEC, 297 F. 2d 116 (2d Cir. 1961).....	64
Canizaro v. Kohlmeyer & Co., 370 F. Supp. 282 (E.D. La. 1974).....	23
Carrol v. United States, 326 F. 2d 72 (9th Cir. 1963).....	47
Chris-Craft Industries v. Bangor Punta Corp., (CCH) Fed. Sec. L. Rep. ¶93,813 (2d Cir. 1973).....	57
Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F. 2d 341 (2d Cir. 1973), cert. den., 414 U.S. 910 (1973).....	23, 56, 57
Chasins V. Smith Barney & Co., 438 F. 2d 1167 (2d Cir. 1970).....	38, 67, 68, 69 82
Christman v. Maristella Compania Naviera, 349 F. Supp. 845 (S.D.N.Y. 1971), aff'd. 468 F. 2d 620 (2d Cir. 1972).....	90
Dale v. Rosenfeld, 229 F. 2d 855 (2d Cir. 1956).....	29, 67, 69, 82, 90
Dallas County v. Commercial Union Assurance Co., 286 F. 2d 388 (5th Cir. 1961).....	49
Demarco v. Edens, 390 F. 2d 836 (2d Cir. 1968).....	35, 37

Dow Chemical v. SS Giovannella D'Amico, 297 F. Supp. 699 (S.D.N.Y. 1969).....	90
Eagle v. Horvath, 241 F. Supp. 341 (S.D.N.Y. 1965).....	38
Eddy v. Prudence Bonds Corp., 165 F. 2d 157 (2d Cir. 1947), cert. den., 333 U.S. 845 (1948).....	90
Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).....	59
Escott v. Barchris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).....	23
Estate of Hooper v. Government of the Virgin Islands, 427 F. 2d 45 (3rd Cir. 1970).....	64
Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 544 (E.D.N.Y. 1971).....	23, 56
Franklin Savings Bank in City of New York v. Levy, 406 F. Supp. 40 (S.D.N.Y. 1975).....	89
Franklin Savings Bank of New York v. Levy, et al., 551 F. 2d 521 (2d Cir. 1977).....	3, 10, 14, 15, 16, 24, 25, 26, 27, 37, 63
Gerstle v. Gamble-Skogmo, 478 F. 2d 1281 (2d Cir. 1973).....	91
Gilbert v. Nixon, 429 F. 2d 348 (10th Cir. 1970).....	29, 58
Hanly v. Securities & Exchange Commission, 415 F. 2d 589 (2d Cir. 1969).....	14, 16, 17, 23, 26, 57
Herzfeld v. Laventhol, Krekstein, Horvath & Horvath, 540 F. 2d 27 (2d Cir. 1976).....	71, 80, 91
Hill York Corp. v. American International Franchises, Inc., 448 F. 2d 680 (5th Cir. 1971).....	29, 58

Hurwitz v. Hurwitz, 136 F. 2d 796 (D.C. Cir. 1943).....	64
Jackson v. Oppenheim, 533 F. 2d 826 (2d Cir. 1976).....	34, 35
Janzen v. Goos, 302 F. 2d 421 (8th Cir. 1962).....	64
Johns Hopkins University v. Hutton, 422 F. 2d 1124 (4th Cir. 1970).....	22
Kahn v. SEC, 297 F. 2d 112 (2d Cir. 1961).....	15, 23
Katz v. Realty Equities Corp. of New York, 406 F. Supp. 802 (S.D.N.Y. 1976).....	91
Kind v. Clark, 161 F. 2d 36 (2d Cir. 1947).....	90
Lehigh Valley Trust Co. v. Central National Bank of Jacksonville, 409 F. 2d 989 (5th Cir. 1969).....	58
Levine v. SEC, 436 F. 2d 88 (2d Cir. 1971).....	23, 24
List v. Fashion Park, Inc., 340 F. 2d 457 (2d Cir. 1965), cert. den., 382 U.S. 811 (1965).....	91
Mallinckrodt Chemical Works v. Goldman, Sachs & Co., 420 F. Supp. 231 (S.D.N.Y. 1976).....	56, 76
Mills v. Electric Auto Lite Co., 396 U.S. 375 (1970).....	39, 40
Muncie Aviation Corp. v. Party Doll Fleet, Inc., 519 F. 2d 1178 (5th Cir. 1975).....	50
Orvis v. Higgins, 180 F. 2d 537 (2d Cir. 1950).....	87, 90
Phillips v. Reynolds & Co., 294 F. Supp. 1249 (E.D. Pa. 1969).....	60, 62

Phillips v. Reynolds & Co., 297 F. 2d 736 (E.D. Pa. 1969).....	55, 60, 61, 62, 63
Radiation Dynamics, Inc. v. Goldmuntz, 464 F. 2d 876 (2d Cir. 1972).....	57
Sanders v. John Nuveen & Co., Inc., 524 F. 2d 1064 (7th Cir. 1975), vacated on other grounds and remanded, 425 U.S. 929 (1976), reversed and remanded, (CCH) Fed. Sec. L. Rep. ¶96,030 (7th Cir. 1977).....	21, 23, 25, 56 59
SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).....	17, 39
SEC v. Shapiro, 349 F. Supp. 46 (S.D.N.Y. 1972), aff'd., 494 F. 2d 1301 (2d Cir. 1974).....	67, 79
SEC v. Texas Gulf Sulphur, 401 F. 2d 833 (2d Cir. 1968), cert. den. sub. nom. Coates v. SEC, 394 U.S. 976 (1968).....	57, 71
Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 495 F. 2d 228 (2d Cir. 1974).....	56, 59, 60
Shaw v. U.S., 403 F. 2d 528 (8th Cir. 1968).....	44
Slade v. Shearson Hammill & Co., Inc., (CCH) Fed. Sec. L. Rep. ¶94,329 (S.D.N.Y. 1973).....	57
Slade v. Shearson Hammill & Co., Inc., 517 F. 2d 398 (2d Cir. 1974).....	42, 57
Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951).....	57
Stamicarbon, N.V. v. American Cynamid Co., 506 F. 2d 532 (2d Cir. 1974).....	90
Stier v. Smith, 473 F. 2d 1205 (5th Cir. 1973).....	29, 58
Straub v. Vaisman and Company, Inc., (CCH) Fed. Sec. L. Rep. ¶95,263 (3rd Cir. 1976).....	68

TSC Industries, Inv. v. Northway, Inc., 426 U.S. 438 (1976).....	38, 63, 64, 80
United States v. Pendergrast, 241 F. 2d 687 (4th Cir. 1957).....	64
United States v. Quong, 303 F. 2d 499 (6th Cir. 1962), cert. den., 371 U. S. 863 (1962).....	47
United States v. Ragano, 520 F. 2d 1191 (5th Cir. 1975).....	46
United States v. United States Gypsum Co., 333 U.S. 364 (1948).....	90
United States Television, Inc. v. Fortnightly Corp., 377 F. 2d 872 (2d Cir. 1967), rev'd on other grounds, 392 U.S. 390, rehearing denied, 393 U.S. 902 (1968).....	90
United States v. Tellier, 255 F. 2d 441 (2d Cir. 1958), cert. den., 358 U.S. 821 (1958).....	46
University Hill Foundation v. Goldman, Sachs & Co., 422 F. Supp. 879 (S.D.N.Y. 1976).....	2, 3, 12, 13, 18, 19, 20, 21, 22, 29, 30, 34, 41, 42, 43, 49, 52, 53, 54, 55, 59, 62, 64, 65, 66, 68, 70, 74, 78, 80, 82, 83, 84, 86, 87, 88, 91
Welch Foods, Inc. v. Goldman, Sachs & Co., (CCH) Fed. Sec. L. Rep. ¶94,806 (S.D.N.Y. 1974).....	21
Wohl v. Blair & Co., 50 F.R.D. 89 (S.D.N.Y. 1970).....	57

STATUTES:

Federal Business Records as Evidence Act, 28 U.S.C. §1732.....	46, 47
---	--------

Securities Act of 1933:

Section 2(11), 15 U.S.C. §77b(11).....	56
Section 11, 15 U.S.C. §77k.....	9, 18, 19, 22, 23, 24, 25, 29
Section 12(2), 15 U.S.C. §77l(2).....	2, 9, 10, 11, 12, 13, 18, 19, 26, 34, 36, 55, 59, 63, 69, 70, 82

Securities Exchange Act of 1934:

Section 10(b), 15 U.S.C. §78j(b).....	2, 63
Section 14(a), 15 U.S.C. §78n(a).....	39, 63
Section 21(a), 15 U.S.C. §78u(a).....	89

OTHER AUTHORITIES:

Federal Rules of Evidence:

Rule 103(a).....	44
Rule 201.....	47
Rule 803(6).....	45, 47, 48
Rule 803(8).....	89
Rule 803(24).....	48, 50

Jacobs, The Impact of Securities Exchange

<u>Act Rule 10b-5 on Broker-Dealers, 57</u>	
Corn L. Rev. 869 (July 1972).....	23

L. Loss, Securities Regulation (2d Ed. 1961).....15

Securities and Exchange Commission Rules

Rule 10b-5, 16 C.F.R. §240.10b-5.....	2, 59
---------------------------------------	-------

Weinstein's Evidence [1976]:

Paragraph 803(6).....	47, 48
Paragraph 903(24).....	48

STATEMENT OF ISSUES PRESENTED FOR REVIEW

A. BY THE APPEAL OF GS:

1. Did GS represent to the FOUNDATION that it had conducted a reasonable and adequate credit investigation of PENN CENTRAL?

2. In early February 1970 when GS learned of PENN CENTRAL'S substantial (1969) year end and fourth quarter losses, the resultant concern of NCO and BROWN BROS. and other adverse information with respect to the financial condition of PENN CENTRAL, did GS have a duty to initiate further inquiry or do anything other than to continue to review public information and rely upon unverified representations of PENN CENTRAL'S management whose candor and competence was by then suspect?

3. Did the District Court clearly err in finding that GS did not conduct a reasonable and adequate credit investigation of PENN CENTRAL after February 4, 1970?

4. Did the District Court clearly err in finding that GS' misrepresentation (that it performed a reasonable credit investigation) "was causally related to the FOUNDATION'S sale"?

B. BY THE APPEAL OF THE FOUNDATION:

5. Were the following facts which GS omitted to disclose to the FOUNDATION material, individually or in the aggregate:

- (a) That GS consistently tried without success to have PENN CENTRAL increase the bankline coverage for its commercial paper from 50% to 100%;
- (b) That immediately after the February 4, 1970 announcement of PENN CENTRAL'S losses, GS took the unprecedented steps of selling \$10,000,000 of its \$15,000,000 inventory of PENN CENTRAL commercial paper to PENN CENTRAL and unilaterally imposed a limit of \$5,000,000 on the PENN CENTRAL paper which it would thereafter hold in inventory;
- (c) That BROWN BROS., a major banking institution which had previously purchased up to 15% of all the commercial paper PENN CENTRAL had outstanding, removed PENN CENTRAL from its list of approved issuers of commercial paper?

6. If any omitted fact was material, did GS have a duty, under the circumstances of this case, to disclose such fact to the FOUNDATION?

7. Did NCO continue to rate PENN CENTRAL commercial paper "Prime" after February 4, 1970 because GS continued to sell the paper?

STATEMENT OF THE CASE

This action was instituted by Plaintiff-Appellee and Cross-Appellant UNIVERSITY HILL FOUNDATION ("FOUNDATION") in 1971. The Complaint alleged that Defendant-Appellant and Cross-Appellee GOLDMAN SACHS & CO. ("GS") violated §12(2) of the Securities Act Of 1933 ("1933 Act"), §10b and Rule 10b-5 of the Securities Exchange Act Of 1934 ("1934 Act"), various state securities laws and the common law with respect to fraud and negligence in connection with the sale to the FOUNDATION of PENN CENTRAL TRANSPORTATION CO. ("PENN CENTRAL") commercial paper in the amount of \$600,000. The trial of the action before the Honorable Morris E. Lasker commenced on October 28, 1975 and was concluded on November 4, 1975. On October 27, 1976, Judge Lasker rendered his decision, University Hill Foundation v. Goldman, Sachs & Co., 422 F. Supp. 879 (S.D.N.Y. 1976), which held that GS was liable pursuant to §12(2), but not with respect to any of the other claims alleged. Judgment in behalf of the FOUNDATION against GS was entered on November 10, 1976. GS and the FOUNDATION have each appealed from different portions of the decision of Judge Lasker.

STATEMENT OF FACTS

Although the significant facts relating to the FOUNDATION

TION'S arguments are considered hereinafter in detail*, a brief factual statement is provided at this point to appreciate the setting and circumstances under which GS' misrepresentations, omissions and inadequate credit investigation occurred.

The FOUNDATION is a California non-profit charitable corporation [Tr. 101, 101a]. Its primary purpose is to raise and channel funds to Loyola University [Tr. 99, 99a; PX-8]. The FOUNDATION is operated by its part-time President, HOWARD FITZPATRICK**, who has served in that capacity from early 1969 to date [Tr. 103, 103a]. Although FITZPATRICK makes the investment decisions of the FOUNDATION [Tr. 104, 104a], he is not an expert or sophisticated investor [Tr. 99-101, 99a]. When the FOUNDATION has available funds, FITZPATRICK invests the same in short term money market instruments such as certificates of deposit or commercial paper [Tr. 105-106, 105a]. Some of these investments were made through or by the UNION BANK of Los Angeles, California, of which the FOUNDATION was a customer and depositor [Tr. 104-105, 104a]. With respect to commercial paper purchases, FITZPATRICK dealt with NOEL G. LEMAY, a Vice-President of the UNION BANK [Tr. 105, 105a].

In purchasing commercial paper, FITZPATRICK'S No. 1 criterion was safety and quality [Tr. 107-108, 107a]. Thus, the FOUNDATION always bought "prime" paper which to FITZPATRICK meant

* See also, 422 F. Supp. 879; Franklin Savings Bank of New York v. Levy, et al., 551 F. 2d 521 (2d Cir. 1977); the opinions cited in the GS Brief (p. 5); The Securities And Exchange Commission Staff Report to the Special House Subcommittee Investigation entitled "The Financial Collapse of the Penn Central Company" [PX-113 (for identification), 1801a].

** FITZPATRICK is a full-time paint contractor [Tr. 100-101, 100a].

"the ultimate [in]safety" [Tr. 109, 109a]. Prior to March 1, 1970, FITZPATRICK had advised LEMAY that the FOUNDATION would only purchase prime commercial paper [Tr. 11, 11a ; Tr. 109, 109a] or "the best quality" [Tr. 110, 110a]. Accordingly, LEMAY only "showed" prime commercial paper to FITZPATRICK and was never instructed to purchase and never purchased commercial paper for the FOUNDATION which was other than prime [Tr. 12, 12a; Tr. 112, 112a]. Moreover, the UNION BANK had a requirement that it would only show its customers commercial paper which was rated prime by the NATIONAL CREDIT OFFICE ("NCO") [Tr. 5, 5a] and GS' Los Angeles Office was aware that the UNION BANK only wanted prime commercial paper [Tr. 7-8, 7a ; Coleman Deposition 112-114, 1148a; Frederickson Deposition 91-92, 1160a].

Apart from requiring a prime rating, UNION BANK (LEMAY) relied entirely on a dealer's reputation in purchasing commercial paper in behalf of its customers. He was aware and relied upon the fact that GS had a credit department which investigated issuers and considered GS to be a "quality house" [Tr. 65, 65a]. So long as it was NCO prime, what was "good enough for Goldman, Sachs was good enough for [LEMAY]" [Tr. 67-69, 67a]. He "relied on GOLDMAN, SACHS completely for quality paper" [Tr. 67, 67a].

Since its organization in 1864, GS has been a dealer in commercial paper and, over the years, has become the largest and most important commercial paper dealer. In 1969 and 1970, GS had approximately 45% of the commercial paper market [Tr. 237, 237a]. When acting as a dealer, GS would, in almost every instance, purchase commercial paper directly from an issuer and

resell it (exclusively in the case of PENN CENTRAL)* as principal to its customers [Tr. 427-429, 427a ; Tr. 225, 225a ; Tr. 437, 437a]. As a result, GS maintained a substantial inventory of commercial paper for the issuers it handled and, as of March 1970, had commercial paper of approximately 200 to 250 issuers in its inventory [Tr. 939, 939a].

GS would only sell the commercial paper of issuers which it deemed creditworthy after it had performed a credit investigation [Tr. 483-484, 483a]. Consequently, by offering the commercial paper of an issuer, GS represented to the potential purchaser that an adequate and reasonable credit investigation had been conducted by it, that the issuer of the commercial paper was creditworthy and that GS recommended the commercial paper for purchase [Weinberg Deposition 41, 1217a; Tr. 806-807, 806a].**

In 1968 and prior to issuing its commercial paper, GS allegedly conducted an initial credit investigation of PENN CENTRAL. The initial credit investigation was performed primarily by JACK VOGEL (the head of GS' commercial paper credit department) [Tr. 556, 556a] and was essentially based upon a review of public information such as the annual reports of PENN CENTRAL, excerpts from Moody's Transportation Manual [Tr. 481, 481a; Tr. 488, 488a; Tr. 493, 493a] and the unverified

*GS' insistence on being the exclusive commercial paper dealer for PENN CENTRAL permitted GS: "to have the sole distribution of the paper", as "a simple economic fact" to have all PENN CENTRAL'S business [Tr. 430, 430a] and to control PENN CENTRAL'S credit [PX-121,1834a; Tr. 430-432, 430a].

**GS ignores the testimony of its own witnesses when it asserts it did not recommend the PENN CENTRAL commercial paper for sale to the FOUNDATION. GS Brief, p. 19.

representations of PENN CENTRAL'S management. Based upon the initial credit investigation and its subsequent "continuing credit investigation", GS concluded that PENN CENTRAL was, at all times prior to its bankruptcy, creditworthy [Tr. 483, 483a; Hoffman* Deposition 36-42, 1176a ; Evans Deposition 57, 1158a; PX-39, 1730a].

On February 4, 1970, PENN CENTRAL publicly announced a \$56 million loss for the year 1969** which included a loss of \$16 million for the fourth quarter of 1969 [PX-11,1717a; Tr. 871, 871a]. Notwithstanding these losses and the following facts, GS did not initiate further inquiry*** regarding PENN CENTRAL'S financial condition, did not change the method for conducting its ongoing credit investigation and continued to rely completely upon public information and unconfirmed representations of management with respect to PENN CENTRAL:

1. PENN CENTRAL gave no advance notice to GS of the announcement regarding its unprecedented losses [Tr. 987, 987a ; PX-11, 1717a].
2. The fourth quarter losses were contrary to the prediction of O'HERRON, the Vice-President-Finance of PENN CENTRAL, that the fourth quarter would be "in the black with a good improvement". [PX-33, 1727a].

*HOFFMAN and EVANS were at different times one of the four credit analysts who worked under VOGEL [Tr. 470, 470a] in connection with GS' continuing credit investigation of PENN CENTRAL. They were each at different times assigned to follow PENN CENTRAL and produced the only written reviews of PENN CENTRAL which appear in GS' credit file [PX-39, 1730a; PX-40 (for identification)].

**Ten times greater than the losses in 1968.

***Other than a luncheon meeting on February 6, 1970 between GS and PENN CENTRAL at which the management of PENN CENTRAL allegedly did a thorough job of explaining its losses [PX-12,1719a; Tr. 891-897, 891a].

3. BROWN BROS. HARRIMAN & CO. ("BROWN BROS."), a highly respected banking institution which had in the past held up to 15% of PENN CENTRAL'S outstanding commercial paper, had removed PENN CENTRAL from its approved list on February 5, 1970 [PX-12,1719a].

4. GS' futile efforts to have PENN CENTRAL obtain, and PENN CENTRAL'S continued inability or unwillingness to obtain, 100% bankline coverage for its commercial paper, infra.

5. The telephone call from ALAN ROGERS of NCO to VOGEL on February 5, 1970 "to express concern over the sharply reduced earnings" announced by PENN CENTRAL [PX-10,1716a].

6. The repurchase by PENN CENTRAL of \$10 million of GS' PENN CENTRAL commercial paper inventory on February 9, 1970 and GS' simultaneous and unprecedented imposition of a \$5 million limit on the amount of PENN CENTRAL commercial paper it would inventory in the future, infra.

7. The untruthfulness and unreliability of PENN CENTRAL management.

In early March 1970, the FOUNDATION had investments of approximately \$600,000 which were maturing at the UNION BANK [Tr. 111, 111a]. On the morning of March 13, 1970, FITZPATRICK telephoned LEMAY and asked him, as he had on prior occasions, to ascertain what prime commercial paper was available as a short term investment for the FOUNDATION'S \$600,000 [Tr. 13-14, 13a ; Tr. 112, 112a]. LEMAY then telephoned the Los Angeles office of GS, requested prime commercial paper and was given the name of PENN CENTRAL and two or three other companies [Tr. 13-16, 13a]. On that same day, LEMAY and FITZPATRICK had a second telephone conversation in the course of which LEMAY informed FITZPATRICK of the three or four different prime commercial papers which GS had advised him were available [Tr. 16-17, 16a ; 112-115, 112a]. FITZPATRICK then elected to pur-

chase two PENN CENTRAL notes having an aggregate face value of \$600,000 because of PENN CENTRAL'S image of size and quality [Tr. 115, 115a], which notes were then purchased by the UNION BANK in behalf of the FOUNDATION on March 13, 1970. In connection with the sale of the notes, GS did not disclose various material facts to the FOUNDATION, infra, or that it failed to conduct an adequate and reasonable credit investigation of PENN CENTRAL after February 4, 1970.

On June 21, 1970, PENN CENTRAL filed a voluntary Petition for Reorganization [Tr. 933, 933a]*. On September 24, 1970, the maturity date of the \$600,000 of PENN CENTRAL commercial paper purchased by the FOUNDATION from GS, the FOUNDATION presented the commercial paper for payment. Payment was refused and remains unpaid to date.

SUMMARY OF ARGUMENT

A. THE FOUNDATION'S ANSWER TO THE ARGUMENTS RAISED BY GS ON APPEAL

The reasoning of the District Court with respect to its holding that GS violated §12(2) of the 1933 Act in connection with its sale of commercial paper to the FOUNDATION was as follows:

1. As the exclusive dealer for and underwriter of PENN CENTRAL commercial paper, GS impliedly represented to the FOUNDATION that (a) in its opinion PENN CENTRAL was creditworthy and (b) a reasonable basis existed for GS' opinion or that a reasonable credit investigation of PENN CENTRAL had been conducted by GS.

2. Although GS may initially have conducted a

*On that date, although its customers held approximately \$80 million of PENN CENTRAL commercial paper, GS held none in its inventory (and had not since in or about April 8, 1970) [DX-CU, 1892a].

reasonable credit investigation of PENN CENTRAL, the adverse facts relating to the financial condition of PENN CENTRAL which GS learned in early February 1970 rendered the initial credit investigation of GS inadequate and imposed a further duty of inquiry on GS to obtain more concrete verification of significant facts regarding PENN CENTRAL. GS did not properly discharge its further duty of inquiry and, accordingly, did not have a reasonable basis for its opinion that PENN CENTRAL was creditworthy. It therefore misrepresented that a reasonable credit investigation of PENN CENTRAL had been conducted, thereby violating §12(2). 422 F. Supp. at 902.

GS contends that no misrepresentation was made to the FOUNDATION in violation of §12(2). In support of this position, GS maintains that because the FOUNDATION did not expect it to conduct more than a routine credit investigation of PENN CENTRAL, GS had no duty (and there was no implied representation which required it) to obtain more concrete verification of facts regarding PENN CENTRAL after February 1970 and, in any event, the District Court erroneously imposed the duty of a "hybrid super-investment adviser" on GS by improperly relying upon an underwriter's duty of investigation pursuant to §11 of the 1933 Act and the duty of a broker-dealer pursuant to the "shingle theory" in holding that GS was required to obtain more concrete verification of facts regarding PENN CENTRAL after February 1970. Accordingly, it is argued that the credit investigation which was performed by GS after February 1970 was reasonable notwithstanding the absence of such verification and, in any event, GS also satisfied the duty of investigation erroneously imposed by the District Court. Finally, GS contends that even assuming GS was required to obtain more concrete verification in February 1970, there is no evidence in the record that further investigation would have produced any additional adverse information about

PENN CENTRAL'S financial condition. Therefore, no liability can be imposed on GS pursuant to §12(2) since no causal relationship between GS' failure to investigate further and the FOUNDATION'S injury was established.

For the reasons set forth hereinafter, the District Court properly concluded that GS made a misrepresentation to the FOUNDATION in connection with the purchase and sale of the PENN CENTRAL commercial paper. As the exclusive seller of PENN CENTRAL commercial paper, GS functioned as both an underwriter and broker-dealer. Consequently, and as it has previously conceded, when GS sold PENN CENTRAL commercial paper it not only represented that in its opinion PENN CENTRAL was creditworthy (and recommended the commercial paper) but also represented that it had a reasonable basis for this opinion. To have a reasonable basis for the opinion, GS was required to perform a reasonable credit investigation of PENN CENTRAL (after February 1970). In determining whether a reasonable basis existed, or whether a reasonable credit investigation was conducted by GS after February 1970, the District Court properly formulated a duty of inquiry requiring more concrete verification by GS of significant information and representations of management with respect to PENN CENTRAL'S financial condition. This duty or standard of inquiry was the same as that articulated by this Court in the virtually identical case of Franklin Savings Bank Of New York v. Levy, et al., 551 F. 2d 521 (2d Cir. 1977), and, therefore, constituted a reasonable and

proper synthesis of and a compromise between the normal duties of a broker-dealer and those of an underwriter of registered securities. The record clearly supports the finding of the District Court that after February 1970, GS failed to perform a reasonable credit investigation of PENN CENTRAL in accordance with its further duty of inquiry, and, consequently, GS misrepresented to the FOUNDATION that an adequate basis existed for its opinion that PENN CENTRAL was creditworthy. The contention that the FOUNDATION did not expect GS to conduct more than a "routine" credit investigation is belied by the testimony that the FOUNDATION assumed GS had an adequate basis for its representation. Finally, not only was there sufficient support in the record to find that the failure of GS to perform a reasonable credit investigation of PENN CENTRAL was causally related to the FOUNDATION'S damage or injury but, when the proper standard of causation is utilized, a causal relationship between GS' misrepresentation and the FOUNDATION'S injury, the requisite causation is, as a matter of law, clearly present. The holding of the District Court should, therefore, be affirmed.

B. ARGUMENTS RAISED BY THE FOUNDATION ON APPEAL

Notwithstanding the imposition of liability on GS pursuant to §12(2) in connection with GS' misrepresentation, the District Court held that GS did not have a duty under §12(2) to disclose the following facts in connection with the FOUNDATION'S purchase of PENN CENTRAL commercial paper, each of which were known to GS:

1. GS' futile efforts to have PENN CENTRAL increase the bankline coverage for its commercial paper from 50% to 100%.

2. GS' \$10,000,000 reduction in inventory of PENN CENTRAL commercial paper and its simultaneous \$5,000,000 inventory limit.

3. The removal by BROWN BROS. HARRIMAN & CO. of PENN CENTRAL commercial paper from its list of approved issuers.

4. The fact that NCO'S prime rating of PENN CENTRAL commercial paper was based on GS' decision to continue selling the same.

The District Court reasoned that GS had no duty to disclose facts "1" through "3" because there was little expectation in the commercial paper market that such facts would be disclosed and because the FOUNDATION (and its agent, UNION BANK) sought only a judgment of PENN CENTRAL'S creditworthiness from GS. The conclusion of the District Court that the nature of the market and expectation of the seller defined, and thereby eliminated, GS' duty to disclose material facts to the FOUNDATION, is clearly erroneous in that it is contrary to existing authority and undermines the philosophy of the securities laws to encourage full disclosure of material facts.

In addition to concluding generally that the omission of facts "1" through "3", supra, did not constitute a violation of § 12(2) by GS, the District Court also specifically held that a:

"...preponderance of the credible evidence does not support the Foundation's claim that the 'Prime' rating [by NCO of PENN CENTRAL] was based exclusively on the defendant's decision to continue sales or that Goldman, Sachs had reason to believe that this was the case." 422 F. Supp. at 897.

Because there is no support for this holding in the record, the

failure of GS to disclose to the FOUNDATION that the "prime" rating of NCO was exclusively based on GS continuing to sell PENN CENTRAL commercial paper in connection with GS' representation that the commercial paper was rated prime by NCO was, contrary to the District Court's conclusion, by itself a violation of §12(2). Therefore, if this Court should adopt the arguments of GS, supra, the decision of the District Court should, nevertheless, be affirmed on the alternative grounds of the FOUNDATION set forth above.

POINT I

AS A MATTER OF LAW GS REPRESENTED TO THE FOUNDATION THAT IT HAD CONDUCTED AN ADEQUATE AND REASONABLE CREDIT INVESTIGATION OF PENN CENTRAL

The District Court held that GS represented to the FOUNDATION that it had conducted a reasonable and adequate credit investigation of PENN CENTRAL:

"We find that Goldman, Sachs impliedly represented that in its opinion, Penn Central was creditworthy. It represented also that there was a reasonable basis for this opinion, i.e. that a reasonable credit investigation had been conducted." 422 F. Supp. at 893 (emphasis supplied).

On appeal, GS appears to argue that because it only represented that it honestly believed PENN CENTRAL was creditworthy the District Court erroneously concluded that GS impliedly represented that it had conducted a reasonable credit investigation. Not

only is this contention without merit as a matter of law but, in addition, it contradicts the position GS has maintained throughout the litigation that it had a reasonable basis for its belief or opinion regarding PENN CENTRAL'S creditworthiness.*

In the virtually identical case** of Franklin Savings Bank of New York v. Levy, et al., 551 F. 2d 521 (2d Cir. 1977) (hereinafter "Franklin"), this Court rejected the argument that GS could only be held liable if its belief that PENN CENTRAL was creditworthy "was dishonestly or recklessly held"*** and applied the holding in Hanly v. Securities & Exchange Commission, 415 F.2d 589 (2d Cir. 1969)****, that a broker-dealer implicitly represents it has an adequate basis for opinions rendered by it to cases involving §12(2) of the 1933 Act. It was therefore held that in selling PENN CENTRAL commercial paper GS impliedly represented to purchasers that it had conducted a reasonable credit investigation of PENN CENTRAL:

"... where a broker dealer makes a representation as to the quality of the security he sells, he impliedly represents that he has an adequate basis in fact for the opinion he renders. We see no reason why that theory is not at least equally appropriate in cases involving §12(2) of the 1933 Act.

Here, Goldman, Sachs became an exclusive source of the Penn Central notes in issue. It was a professional vendor admittedly recommending this paper for sale to an institution authorized by

*Similarly, GS' contention that it made no recommendation regarding the PENN CENTRAL commercial paper (GS Brief, p. 19) is legally untenable and contradicts its own witnesses. See Weinberg Deposition 41, 1217a ; Tr. 806, 806a ; and authorities cited, *infra*.

**In the instant case, the FOUNDATION purchased \$600,000 of PENN CENTRAL commercial paper on March 13, 1970. In Franklin, the purchase was made on March 16, 1970 (the Monday following Friday, March 13, 1970) in the amount of \$500,000. Both the FOUNDATION and the purchaser in Franklin would or could only purchase "prime" commercial

(Footnotes continued on next page)

statute only to invest in prime paper. Such an undertaking implies that Goldman, Sachs, had conducted an ongoing investigation of Penn Central's financial condition. If Goldman, Sachs, failed to exercise reasonable professional care is [sic] assembling and evaluating the financial data, particularly in view of the worsening condition of Penn Central, then its representation that the paper was creditworthy and high quality was untrue in fact and misleading no matter how honestly but mistakenly held." Franklin at 527.

As in Franklin, with respect to the instant facts GS was a professional vendor of, and the exclusive source for, PENN CENTRAL commercial paper. In addition, similar to the purchaser in Franklin, and although not restricted by statute, the FOUNDATION would only purchase commercial paper which was rated "prime" by NCO and GS knew that the UNION BANK would only accept "prime" commercial paper. Accordingly, when GS offered and sold PENN CENTRAL commercial paper to the FOUNDATION and concededly* represented that in its opinion, or in its honest belief, PENN CENTRAL was creditworthy, it impliedly represented, as this Court held in Franklin, that it had an adequate and reasonable basis for its opinion or that it had conducted an adequate and reasonable credit investigation of PENN CENTRAL prior to March 16, 1970.

Notwithstanding the fact that GS has, until now, consistently maintained that it impliedly represented that it had conducted a reasonable credit investigation of PENN CENTRAL**, it now apparently

(Footnotes cont'd.)

paper, infra. In addition, the individuals in Franklin who made the purchase decision were clearly more knowledgeable than either FITZPATRICK or LEMAY.

***Franklin at 91,356.

****See also, 3 L.Loss, Securities Regulation 1483 (2d Ed. 1961); Kahn v. SEC, 297 F.2d 112 (2d Cir. 1961).

*See GS Brief, p. 9.

**Thus, in its Trial Memorandum, GS stated:

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takes issue with that position. GS now contends (without citation of authority) that because the FOUNDATION was "not restricted by statute or otherwise to buying only paper rated 'prime'" (GS Brief, p. 19) and because neither the FOUNDATION nor the participants in the commercial paper market in general expected GS to perform a reasonable credit investigation as defined by the District Court (GS Brief, p. 20), such duty or representation can not be implied.

As indicated, supra, although not restricted by statute as was the purchaser in Franklin, the FOUNDATION (through the UNION BANK) nevertheless similarly restricted the quality of the commercial paper it purchased to that rated "prime" by NCO. Consequently, for all intents and purposes, the FOUNDATION restricted itself to the purchase of NCO "prime" commercial paper and, therefore, in relation to GS, can not be distinguished from the purchaser in Franklin.

More significantly, however, even if the FOUNDATION were not so restricted, a difference in the nature of what constitutes a permissible investment for a purchaser cannot dictate whether a broker-dealer or underwriter must, as a matter of law, have an adequate basis for an opinion rendered by it. Such a conclusion would contradict the holding in Hanly v. SEC, supra, and Franklin. Likewise, whether

(Footnote cont'd.)

"We concede that a professional, such as Goldman, Sachs, in expressing an opinion must have a reasonable basis for the judgment, and we submit that the sole issue in this case is whether on the date plaintiff purchased its commercial paper Goldman, Sachs, in fact, had a reasonable basis for concluding that Penn Central was creditworthy." GS Trial Memorandum, p. 52.

"The Courts have recognized that in certain circum-

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an adequate or reasonable basis must exist for an opinion which is rendered can not be determined by the expectation of the individual purchasers or that of the commercial paper market in general. Aside from the fact that the UNION BANK in behalf of the FOUNDATION expected GS to have an adequate basis for its opinion [Tr. 65-69, 65a] and there is no evidence in the record that the commercial paper market in general did not have a similar expectation, no court has ever held or intimated that such a rule should obtain. Not only would such a rule be, again, inconsistent with Hanly and Franklin but it would supplant the present thrust and purpose of the securities laws* by imposing upon the purchaser (as opposed to the seller) a duty to make its expectations regarding the basis for the seller's opinion known to the seller** (as opposed to requiring the seller to have an adequate basis for the opinion).

In view of the foregoing, it must be concluded that the District Court properly held that GS represented to the FOUNDATION that it had an adequate or reasonable basis for its opinion that PENN CENTRAL was creditworthy or that GS conducted an adequate and reasonable credit investigation of PENN CENTRAL. Moreover, assuming, arguendo, that it was error to imply such a representation, GS none-

(Footnote cont'd.)

stances a seller of securities who expresses an opinion about such securities must have an adequate and reasonable basis for his statement.***In the instant case, the duty so imposed is one of investigation and analysis which arises ... from the general statement --express or implied -- that Goldman, Sachs only sells commercial paper of issuers which it believes to be creditworthy." GS Trial Memorandum, pp. 71-72.

*See SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963) and Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), infra.

**Indeed, the compressed selling day and sales transactions in the commercial paper market would not afford purchasers a sufficient amount of time to apprise sellers of their expectations.

theless violated §12(2) in failing to disclose the material fact to the FOUNDATION that it did not perform a reasonable and adequate credit investigation of PENN CENTRAL, infra.

POINT II

THE DISTRICT COURT PROPERLY CONCLUDED THAT GS DID NOT CONDUCT AN ADEQUATE AND REASONABLE CREDIT INVESTIGATION OF PENN CENTRAL AFTER FEBRUARY 4, 1970 AND THEREFORE VIOLATED §12(2)

The District Court held that after February 4, 1970, GS did not conduct an adequate or reasonable credit investigation of PENN CENTRAL because it continued to rely routinely on unconfirmed public data and representations of PENN CENTRAL'S management and failed to more closely investigate the financial condition of PENN CENTRAL after it learned facts which indicated PENN CENTRAL was in financial trouble. In reaching this conclusion, the District Court held that as the sole and exclusive distributor of PENN CENTRAL commercial paper, GS functioned both as a broker-dealer and as an underwriter (422 F.Supp. at 900). After reviewing and analyzing the existing case law, the District Court defined an independent standard of reasonable investigation for GS in its dual role within the context of the circumstances presented in this case based upon a synthesis of the respective duties of investigation of a broker-dealer (pursuant to the "shingle theory") and of an underwriter (pursuant to §11 of the 1933 Act) and held that GS did not properly discharge this duty. Accordingly, the District Court concluded that GS misrepresented to the FOUNDATION that it had conducted a reasonable or adequate credit investigation or that it had a reasonable or adequate basis for its opinion that PENN CENTRAL was creditworthy and, consequently, violated

§12(2) of the 1933 Act:

"The question, however, is not whether Goldman, Sachs conducted a reasonable credit investigation in May or June 1970, but whether by March 13, 1970, the date of the Foundation's purchase, there were sufficient storm warnings as to the Company's insecure condition to render Goldman, Sachs' normal procedures inadequate and to require more concrete verification of management representations and projections. We conclude that such cause existed at least upon the disclosure of the 1969 fourth quarter and year end figures in early February 1970. At that point there were surely enough signs that the Company was in serious financial straits to render the defendant's exclusive reliance on publicly available data and the unverified representations of management inadequate to meet its obligation to the investing public. Its failure to inquire more closely into the basis for the statements of Bevan and O'Herron at the February 6th meeting, to require access to Company records and projections, to verify them or more aggressively to consult with other financial institutions which dealt with the Company for their appraisal of the Company's position, rendered Goldman, Sachs' ongoing credit investigation unreasonable..." 422 F. Supp. at 902.

On appeal, GS contends that the duty or standard of reasonable investigation imposed by the District Court on GS was erroneous in that:

(1) The "shingle theory" in connection with a broker-dealer's duty of investigation is not applicable to the instant facts by virtue of the relationship between GS and the FOUNDATION and the expectation of the FOUNDATION (and the commercial paper market in general) with respect to GS performing a credit investigation of PENN CENTRAL, and

(2) An underwriter's duty of investigation pursuant to §11 of the 1933 Act is not applicable to the instant facts because commercial paper is exempt from registration under the 1933 Act.

In addition, GS maintains that it properly discharged the duty of investigation imposed by the District Court and, in any event, the FOUNDATION did not establish (and the District Court erroneously did not

require) the existence of a causal relation between the failure of GS to conduct a reasonable credit investigation and the damage to the FOUNDATION.

As demonstrated heréinafter, the standard of reasonable investigation formulated and adopted by the District Court was proper, GS did not conduct a credit investigation in accordance with such standard and the requisite causation for recovery pursuant to §12(2) was established.

A. THE DISTRICT COURT IMPOSED A PROPER
STANDARD OF INVESTIGATION ON GS.

The credit investigation performed by GS prior to February 1970 was based" ... upon publicly available information and the unverified representations of management" (422 F.Supp. at 901) and an analysis of such information which was performed by VOGEL to a large extent in his head without the retention of any written notes in connection therewith [Tr. 642, 642a ; Tr. 638, 638a].* Although the District Court concluded that GS' "normal" credit investigation may have been adequate prior to February 4, 1970 (422 F.Supp. at 902), it further held that as a result of the adverse facts regarding the financial condition of PENN CENTRAL which GS learned at or about that time**, the normal procedures of GS became inadequate and unreasonable.

*See also 422 F.Supp. at 891-892; Tr. 839-841, 839a ; Tr. 481-482, 481a ; and POINT II (B), *infra*.

**The following adverse facts or "storm warnings" became known on or about February 4, 1970: the substantial losses of PENN CENTRAL with respect to the fourth quarter of 1969 and 1969 as a whole, the fact that BROWN BROS. removed PENN CENTRAL from its approved list of commercial paper issuers, the fact that O'HERRON'S prediction regarding the earnings of PENN CENTRAL for the fourth quarter of 1969 was wrong,

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To have performed a reasonable and adequate credit investigation of PENN CENTRAL after February 4, 1970, GS should have (but did not):

"...require[d] more concrete verification of management representations and projections... inquire[d] more closely into the basis for the statements of...[management], require[d] access to Company records and projections...verif[ied] them or more aggressively...consult[ed] with other financial institutions which dealt with the Company for their appraisal of the Company's position..." (422 F.Supp. at 902) (emphasis supplied).

"...[and generally been] far more cautious and inquisitive than it was...[and made management] demonstrate a realistic basis for their [its] optimism [regarding PENN CENTRAL]." 422 F.Supp. at 904.

Thus, in the context of the February 1970 adverse facts or "storm warnings" regarding PENN CENTRAL, the District Court essentially imposed a duty of further inquiry (as opposed to mere review) on GS with respect to significant information regarding PENN CENTRAL's financial condition. It did not mandate, as GS contends, verification of all information by all commercial paper dealers at all times.*

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the failure of PENN CENTRAL to give GS advance notification of the fourth quarter and 1969 losses, and the telephone call to VOGEL from ROGERS of NCO seeking reassurance regarding PENN CENTRAL'S financial condition. The contention of GS that the announcement of PENN CENTRAL'S 1969 losses did not constitute a "storm warning" because thereafter investors continued to purchase PENN CENTRAL commercial paper and banks extended loans to PENN CENTRAL (GS Brief, p. 34 et seq.) is untenable because: (1) although the 1969 losses were sufficient alone to cause concern regarding PENN CENTRAL'S financial condition, when considered together with the additional adverse facts or storm warnings (some of which were individually "material", see POINT IV, infra) a re-evaluation of PENN CENTRAL was clearly required; (2) as the exclusive broker-dealer and underwriter of PENN CENTRAL commercial paper, GS could not rely upon the opinions or reactions of others in the commercial paper market, particularly those of banks (see, Sanders v. John Nuveen & Co., Inc., supra, and Welch Foods, Inc., v. Goldman, Sachs & Co., (CCH) Fed. Sec. L. Rep. ¶94,806 (S.D.N.Y. 1974), and especially

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It merely required GS to obtain more concrete verification of the representations and projections of PENN CENTRAL'S management in view of the relationship between GS and PENN CENTRAL and after the February 4, 1970 adverse financial facts became known.

In the absence of case law directly in point, the District Court synthesized the foregoing duty of further inquiry or standard of reasonable investigation from authorities relating to a broker-dealer's duty of investigation** in accordance with the "shingle theory" and those which concerned the investigative duty of an underwriter*** (422 F.Supp. at 898-900). Based on a review and analysis of such authorities, the District Court determined that a broker-dealer has a flexible duty of investigation which increases as a function of its relation to and knowledge of the issuer, which duty would require verification of information regarding the issuer in certain circumstances such as actual knowledge of adverse facts relating to the issuer. With respect to the duty of an underwriter to investigate (as formulated by other courts pursuant to §11 of the 1933 Act in connection with misrepresentations and omissions in registration statements), the District Court found that because of its more substantial relationship to the issuer and greater role in selling the issuer's securities, an underwriter has a significantly higher duty of investigation than does a broker-dealer. It must occupy a skeptical position adverse to that of the issuer and must

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when GS possessed information which was not publicly known (e.g. O'HERRON'S erroneous predictions). See John Hopkins University v. Hut-ton, 422 F.2d 1124 (4th Cir. 1970).

*Thus, the District Court held: "It would be unreasonable to require commercial paper dealers to conduct far-reaching, first hand verifi-

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verify statements of management and information regarding the issuer.

Based on the foregoing, it is clear that the duty of investigation or inquiry imposed by the District Court in this case on GS in its dual capacity as an underwriter (albeit not in connection with registered securities) and a broker-dealer represented a synthesis of the respective duties of investigation of underwriters and broker-dealers and constituted a compromise between and within the spectral range of their duties. Thus, because GS was more than a broker-dealer, the District Court did not limit GS' duty to the mere review of information. Likewise, because GS was less than an underwriter of registered securities, the District Court did not "import wholesale" the duty of complete verification pursuant to §11. The synthesized duty of inquiry and "more concrete verification" imposed by the District Court merely required GS to do something more than review public information and uncritically accept statements of management after February 4, 1970 when, it is submitted, a reasonable man would have had cause to question the financial condition of PENN CENTRAL*. At that point, GS could no longer conduct its credit investigation in the passive reviewing role of a normal broker-dealer and had to assume a

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cation of all issuing companies ... and thereby to provide all disappointed purchasers with a cause of action against the dealer for failure to do so. (Our findings below are based solely on the particular facts of this case.)" 422 F.Supp. at 901.

**Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969); Kahn v. SEC, 297 F.2d 112 (2d Cir. 1961); Canizaro v. Kohlmeyer & Co., 370 F.Supp. 282 (E. D. La. 1974); Levine v. SEC, 436 F.2d 88 (2d Cir. 1971); Jacobs, The Impact of Securities Exchange Act Rule 10b-5 on Broker Dealers, 57 Corn L.Rev. 869 (July 1972).

***Feit v. Leasco Data Processing Equipment Corp., 332 F.Supp. 544 (E.D.N.Y. 1971); Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir. 1973), cert.den., 414 U.S. 910 (1973); Sanders v. John Nuveen & Co., Inc., 524 F.2d 1064 (7th Cir. 1975), vacated on

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more affirmative inquiry position approximating, although not the same as, a §11 underwriter. The representations and projections made by PENN CENTRAL'S management in February 1970 required further verification or confirmation. Therefore, under the circumstances of this case, the standard of reasonable investigation formulated by the District Court and the duty it imposed on GS was proper. Indeed, it is no more demanding under the circumstances of February 4, 1970 than that imposed in Levine v. SEC, 436 F.2d 88 (2d Cir. 1971), wherein this Court required a broker-dealer which had a long standing relationship with an issuer (and therefore the opportunity for relatively easy access to information concerning the issuer) to verify documents and statements made by management concerning the issuer (as opposed to merely relying on the same) by reason of the existence of "actual knowledge or warning signals" with respect to the issuer's financial condition.

Similarly, in Franklin, this Court held that the proper duty of investigation to be imposed on GS as the exclusive source and professional vendor of PENN CENTRAL commercial paper was:

"...to exercise reasonable professional care is [sic] assembling and evaluating the financial data [of the issuer], particularly in view of the worsening condition of Penn Central..." Id. at 527.

Therefore, in Franklin, GS was required to assemble and evaluate information regarding PENN CENTRAL under the circumstances of February 1970 with reasonable professional care. The District Court held

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other grounds and remanded, 425 U.S. 929 (1976); Escott v. BarChris Construction Corp., 283 F.Supp. 643 (S.D.N.Y. 1968).

*Thus, both NCO (ROGERS) and BROWN BROTHERS clearly questioned PENN CENTRAL'S creditworthiness.

that reasonable care under the circumstances of the February 1970 adverse financial facts and the relationship between GS and PENN CENTRAL required GS to initiate further inquiry and obtain more concrete verification of the financial representations and projections of PENN CENTRAL'S management, or, in the words of this Court, to reasonably assemble and evaluate financial data in view of PENN CENTRAL'S worsening financial condition. Although this Court did not expressly require verification of information, not only is such term implicit in the requirement that GS assemble and evaluate data of PENN CENTRAL with reasonable, professional care, but, in any event, the District Court did not unqualifiedly require verification, merely more concrete verification. Consequently, the District Court's standard of reasonable investigation, predicated on a synthesis of the duties of a broker-dealer and of an underwriter, the dual roles in which GS was functioning, was not only proper but has, for all intents and purposes, already been adopted by this Court.*

The arguments of GS do not compel a contrary conclusion. As indicated above, the District Court did not adopt the standard for a §11 underwriter with respect to GS' duty to conduct a reasonable or adequate credit investigation of PENN CENTRAL. Similarly, there is no merit to the argument of GS that consideration of the "shingle theory" by the District Court in formulating GS' duty of reasonable investigation was improper (and distinguishes the instant case from Franklin) on the grounds that the sale of PENN CENTRAL

*See also, Sanders v. John Nuveen & Co., Inc., supra.

commercial paper to the FOUNDATION did not involve a "boiler room" situation and that the FOUNDATION had no relationship with GS.

Although GS admittedly did not sell PENN CENTRAL commercial paper to the FOUNDATION from a "boiler room", this Court has held that the absence of a "boiler room" does not diminish the applicability of the "shingle theory":

"The Commission having previously refused to condone misrepresentation in the absence of a boiler room ... we specifically reject petitioners' argument that absence of boiler room operations here is a defense to a charge of misrepresentation." Hanly v. SEC, 415 F.2d 589, 597 n. 14 (2d Cir. 1969) (emphasis supplied) (citations omitted).

Thus, in Franklin, where no boiler room existed, the "shingle theory" was reaffirmed:

"We have held that where a broker-dealer makes a representation as to the quality of the security he sells, he impliedly represents that he has an adequate basis in fact for the opinion he renders. Hanly v. Securities & Exchange Commission, 415 F.2d 589, 596-977(2d Cir. 1969). We see no reason why that theory is not at least equally appropriate in cases involving §12(2) of the 1933 Act." Franklin at 527.*

Similarly, the propriety of the District Court's reference to the "shingle theory" can not be questioned by reason of the (alleged lack of the) FOUNDATION'S relationship to GS. Notwithstanding GS' contention** , the FOUNDATION (together with the UNION BANK) clearly had a relationship to GS in connection with its purchase of PENN

*Not only is the "[shingle] theory...at least equally appropriate" in §12(2) cases but, by virtue of its application in Franklin, it is not restricted to cases prosecuted by the SEC.

**GS Brief, p. 18.

CENTRAL commercial paper, if not the same relationship GS had with the purchaser in Franklin.^{*} Accordingly, assuming that the "shingle theory" is, in the first instance, predicated upon the relationship between a broker-dealer and its customer (as opposed to the relationship of the broker-dealer to the issuer, supra, and the overriding purpose of the securities laws to foster full disclosure), the FOUNDATION possessed the requisite relationship.

Equally unfounded is GS' argument that the FOUNDATION (and the commercial paper market in general) did not expect GS to perform the type of credit investigation in connection with PENN CENTRAL which was required by the District Court and that therefore the duty of investigation imposed was improper. Although FITZPATRICK may have had no explicit expectation regarding the investigation which GS would perform of PENN CENTRAL, the FOUNDATION (through the UNION BANK) assumed/expected GS to make a credit investigation [Tr. 65-67, 65a]:

"Q. So you [LEMAY] knew they [GS] were making some kind of investigation, didn't you?

A. That would be routine.[**]

Q. It would be routine?

A. Yes.

Q. So you assumed that that was the case?

A. That is correct . . .

* * *

Q. Did you [LEMAY] understand that its [GS'] credit department's function was to make credit investigations?

A. That is correct.

Q. Of commercial paper issuers?

A. That is correct.

Q. Did you assume they were doing one on Penn Central?

A. They published statements on those items.

Q. They published financial statements on Penn Central?

*As indicated, supra, there is no substantive distinction between the FOUNDATION and the purchaser in Franklin with respect to GS.

**As opposed to making a "routine investigation" as contended by GS. GS Brief, p. 20

- A. On some of these items.
 Q. So you knew they were collecting information on Penn Central then?
 A. That is correct. It's an accepted practice, sir.
 Q. To make an investigation?
 A. Not for me, for them.
 Q. I am asking you what you understood at the time about Goldman, Sachs' practice?
 A. I relied on Goldman, Sachs completely for quality paper.

* * *

THE COURT: Secondly, you knew Goldman, Sachs had a credit department and, third, it was customary for outfits like Goldman, Sachs to make credit investigation in regards to such matters?

[LEMAY]: Correct.

* * *

THE COURT: And, fifth, although you didn't specifically know whether they had made an investigation as to this particular line of notes, you assumed they did?

[LEMAY]: That is correct."

Thus, the FOUNDATION assumed/expected GS to conduct a credit investigation of PENN CENTRAL which included the collection of information. Moreover, based upon the reasonable inference that LEMAY expected GS to review the information collected by it and the policy of the UNION BANK that if there were any "signs of alarm" with respect to a company it would refrain from investing in it until the company's condition was investigated [Tr. 34, 34a], it can further be assumed that LEMAY expected GS to assure itself of PENN CENTRAL'S operations if GS perceived "signs of alarm" in the course of its collection and review of information regarding PENN CENTRAL. Consequently, it can reasonably be concluded that the FOUNDATION expected GS to conduct precisely the type of credit investigation required of GS by the District Court. Likewise, in the absence of GS proffering any proof with respect to the expectation of the commercial

paper market in general, it is more reasonable to assume that the market expectation was substantially the same as that of the FOUNDATION, a member of the market, than to presume that the alleged access of the commercial paper market to the same information about PENN CENTRAL which GS was capable of obtaining* totally vitiated any expectation at all. Finally and perhaps most significantly, GS has set forth no authority which supports the proposition that the duty of reasonable investigation is, or should be, predicated upon the expectations of the purchaser or the market in general**. To the contrary, it is submitted that a broker-dealer/underwriter's duty of investigation is a function, as the District Court held based on the authority it reviewed in its decision, of the:

"...relationship between Penn Central and Goldman, Sachs, the latter's access to information, the nature of the data it relied upon and the presence or absence of 'warning signals'." 422 F.Supp. at 900.

Accordingly, the District Court properly utilized the broker-dealer "shingle theory" in conjunction with the duty of an underwriter pursuant to §11 in formulating an independent standard of reasonable investigation with respect to the duty of GS to conduct a credit investigation of PENN CENTRAL and therefore, the District Court's opinion is not "in a word ... inconsistent with Franklin."***

*GS Brief, p.20. In this connection, it should be noted that an investor's access to information elsewhere does not relieve GS of its duty to disclose. Stier v. Smith, 473 F.2d 1205 (5th Cir. 1973); Dale v. Rosenfeld, 229 F.2d 855 (2d Cir. 1956); Hill York Corp. v. American International Franchises, Inc., 448 F. 2d 680 (5th Cir. 1971); Gilbert v. Nixon, 429 F. 2d 348 (10th Cir. 1970).

**Indeed, in view of the abbreviated or compressed selling day with respect to commercial paper and the alleged consequent inability to disclose any information regarding an issuer, it is submitted that a more thorough investigation or analysis of the issuer should be required or expected to insure that, in the absence of any factual disclosure, the issuer is financially sound.

***GS Brief, p. 13.

B. THE DISTRICT COURT'S CONCLUSION THAT GS
DID NOT CONDUCT A REASONABLE AND ADEQUATE
CREDIT INVESTIGATION WAS NOT CLEARLY ERRONEOUS

As indicated, supra, the District Court (properly) held that for GS to have conducted an adequate and reasonable credit investigation of PENN CENTRAL after February 4, 1970, it should have obtained more concrete verification of the financial representations and projections of PENN CENTRAL'S management. The District Court then concluded that GS did not conduct a reasonable or adequate credit investigation in accordance with this standard by reason of GS' :

- (1) "...uncritical acceptance of Company representations..." 422 F.Supp. at 903.
- (2) "...uncritical acceptance of...forecasts and projections..." Id.
- (3) "...complete absence of any effort to confirm that there was some factual basis for [the forecasts and projections]..." Id.
- (4) "...[failure to request] copies of the Company's projected first quarter [1970] earnings as they were revised on a bi-weekly basis..." Id. at 904.
- (5) "...failure to inquire regarding PENN CENTRAL'S lack of adequate contingency planning." Id.
- (6) "...absence of inquiry into railroad operations..." Id.
- (7) "...[failure to] have inquired of Brown Brothers, Harriman as to the reasons it had removed the Company from its list..." Id.
- (8) "...[lack of] inquiry into the circumstances surrounding a \$50 million bridge loan..." Id.
- (9) "...[failure] to put Company management to the test and make them demonstrate a realistic basis for their optimism." Id.*

*GS also failed to ascertain why PENN CENTRAL would not obtain additional banline coverage for its commercial paper. See PX-12, 1719a; PX-13, 1721a.

The record clearly supports the conclusion of the District Court that after February 4, 1970, GS failed to verify, confirm or conduct further inquiry with respect to the representations and projections of PENN CENTRAL'S management and the records of PENN CENTRAL or to productively consult with other financial institutions. Indeed, as demonstrated hereinafter, aside from the pro forma* meeting with PENN CENTRAL management on February 6, 1970, GS neglected to make any additional inquiry in connection with its credit investigation of PENN CENTRAL after February 4, 1970. Thus:

- (1) VOGEL, the manager of the credit department at GS, never requested anyone to update the GS credit file for PENN CENTRAL [Tr. 561-563, 561a].
- (2) VOGEL never inquired of BROWN BROS. regarding its removal of PENN CENTRAL commercial paper from its approved list of investments and WILSON, the head of GS' commercial paper department, failed to make any productive inquiry [Tr. 610-611, 610a ; Tr. 955-957, 955a].
- (3) VOGEL made no inquiry of PENN CENTRAL management regarding subjects discussed at the February 6, 1970 meeting with GS at which he was not present [Tr. 612, 612a].
- (4) "In terms of making projections [regarding PENN CENTRAL'S financial situation], we [GS] asked what happened [regarding O'HERRON'S inaccurate fourth quarter profit projection] and he explained it to us. We were satisfied with the explanation." [Tr. 656, 656a].
- (5) GS did not verify documents filed with the ICC but merely reviewed papers and documents given to GS by PENN CENTRAL [Tr. 656-657, 656a].
- (6) WILSON did not ask for a written budget from PENN CENTRAL [Tr. 895, 895a].

*Since VOGEL had told ROGERS of NCO on February 5, 1970 that GS would continue to sell PENN CENTRAL commercial paper [PX-10, 1716a], GS had clearly decided prior to the February 6, 1970 meeting with PENN CENTRAL management that PENN CENTRAL was "creditworthy" without the benefit of any discussion with management or any other further credit investigation or inquiry. Similarly, WILSON told O'HERRON on February 5, 1970 and prior to the meeting that GS would continue to sell PENN CENTRAL commercial paper [PX-11, 1717a].

- (7) WILSON did not ask for weekly, bi-weekly or monthly projections or internal financial documents from PENN CENTRAL [Tr. 895, 895a; Tr. 1027, 1027a].
- (8) WILSON never requested the existing financial forecasts of PENN CENTRAL for the first quarter of 1970 [PX-101-103, 1785a] [Tr. 897, 897a].
- (9) WILSON saw no need to ask and did not ask for underlying documents and assumptions regarding the representations of PENN CENTRAL at the February 6, 1970 meeting [Tr. 897-899, 897a].
- (10) It was not WILSON'S responsibility and he did not review underlying documents in connection with PENN CENTRAL [Tr. 947, 947a].
- (11) GS did not ask PENN CENTRAL if any bank had declined to give PENN CENTRAL banklines of credit [Tr. 994, 994a].
- (12) GS did not think it was necessary to ask and did not ask PENN CENTRAL to provide financial budget documents despite the fact that there was no reason to doubt that any request by GS would be honored by PENN CENTRAL [Tr. 995-996, 995a].
- (13) WILSON did not ask PENN CENTRAL or their accountants about the basis for the extraordinary 1969 fourth quarter charges [Tr. 1012-1015, 1012a].
- (14) WILSON relied on the statements of PENN CENTRAL [Tr. 1015, 1015a].
- (15) Because representations, statements and projections were being made by "senior financial officers" of PENN CENTRAL, there was no need to obtain "back-up" documents in connection with the same. [Tr. 1024, 1024a].

Based upon the foregoing, it is clear that notwithstanding the adverse information regarding PENN CENTRAL which GS learned by February 6, 1970, GS made no further inquiry of PENN CENTRAL'S financial condition with the exception of the one pro forma meeting with PENN CENTRAL'S management. No additional measures were undertaken by GS to confirm or obtain more concrete verification of the representations and projections made by PENN CENTRAL'S management. Nor was the methodology utilized by GS in connection with its credit

analysis more than perfunctorily updated. VOGEL continued to calculate the creditworthiness of PENN CENTRAL inside his head based primarily upon public information and documents [Tr. 481-483, 481a ; Tr. 492-493, 492a ; Tr. 505-506, 505a ; Tr. 544-550, 554a ; Tr. 565-566, 565a ; Tr. 638-643, 638a ; Tr. 841-842, 841a]. In view of the absence of any further inquiry or change in procedure with respect to the credit analysis, there existed more than sufficient evidence upon which the District Court could conclude that GS failed to conduct an adequate and reasonable credit investigation of PENN CENTRAL after February 4, 1970 in accordance with the standard it articulated, supra. Indeed, GS can not, and virtually does not, contend that it discharged the duty of further inquiry imposed by the District Court. Thus, with respect to the adverse facts regarding PENN CENTRAL'S financial condition in or about February 4, 1970, GS concedes that it merely responded by or with:

"...its interviews of top financial management, its continued analysis upon the facts provided by management[*] and its ongoing monitoring of the Penn Central situation." GS Brief, p. 34.

Accordingly, the District Court's finding that GS did not conduct a reasonable credit investigation was not clearly erroneous.

*Although GS contends that VOGEL "...returned to his continuing analysis of the creditworthiness of Penn Central..." (GS Brief, p. 32) (emphasis supplied) and that a credit analysis was "...conducted in the days and weeks after the February 6 meeting..." (GS Brief, p.33), thereby implying that some additional analysis or further inquiry resulted from the adverse facts regarding PENN CENTRAL, there is only evidence which contradicts the implication that VOGEL or GS did anything other than merely to continue its prior procedure of reviewing the creditworthiness of PENN CENTRAL based on public information and accepted representations of management.

POINT III

THE CAUSATION REQUIREMENT OF
§12(2) WAS SATISFIED

GS maintains that the District Court's imposition of liability pursuant to §12(2) was improper because the FOUNDATION failed to establish a "causal nexus" between GS' duty to investigate and damage to the FOUNDATION. GS Brief, pp. 29-30. However, as demonstrated hereinafter, when the proper test for causation pursuant to §12(2) is considered - causal relationship between the misrepresentation of GS (as opposed to GS' failure to discharge its investigative duty) and damage to the FOUNDATION, the requisite causal nexus is clearly present. Moreover, and in any event, because GS would have learned* additional material adverse information regarding the financial condition of PENN CENTRAL if it had discharged its duty of conducting an adequate and reasonable credit investigation after February 4, 1970, a causal nexus also exists between the failure of GS to perform its investigative duty and the damage to the FOUNDATION.

A. CAUSATION PURSUANT TO §12(2) EXISTS BETWEEN
THE MISREPRESENTATION BY GS AND THE FOUNDATION'S DAMAGE

Although GS relies upon the decision of this Court in Jackson v. Oppenheim, 533 F. 2d 826 (2d Cir. 1976), for the proposition that no causation was established by the FOUNDATION, the District Court's contrary finding that "...[the untruth or misrepresentation of GS] was causally related to the sale" (422 F. Supp. at 905) was similarly predicated on that case. The conflicting

*Assuming it did not already know.

interpretations of Jackson by GS and the District Court are attributable to the fact that GS (improperly) construes Jackson as requiring a "causal nexus" between its failure to discharge its investigative duty and the FOUNDATION'S injury whereas the District Court adheres to the actual test of causation established by Jackson, a causal relationship between GS' misrepresentation and damage to the FOUNDATION.

In Jackson, this Court reaffirmed that §12(2) of the 1933 Act does not require that a misrepresentation cause or have a decisive effect in connection with the sale of a security but merely that "...the communication as a whole must have been instrumental in the sale..." (533 F. 2d at 830):

"We are aware, of course, that the statement that 'reliance' need not be proven by plaintiffs in 12(2) actions has been broadly read by several courts...Their purport is that the plaintiff need not prove that the challenged communication had a 'decisive effect' in his decision to buy the stock...But we do not view those cases as suggesting that the requirement that the sale or offer be 'by means of' a misleading communication should have no meaning whatsoever. Where liability is not based on an offer containing a misleading communication...but is based on a sale, Section 12(2) requires there to be some causal relationship between the challenged communication and the sale, even if not 'decisive'. In short, the communication must have been intended or perceived as instrumental in effecting the sale." Id., n.8, (citations omitted) (emphasis supplied).*

In the instant case, a causal relationship between the "challenged communication" (the (mis)representation of GS that it performed an adequate credit investigation, supra) and the sale of PENN CENTRAL commercial paper by GS to the FOUNDATION was established.

LEMAY assumed that GS had conducted a credit investigation of

*See also, DeMarco v. Eders, 390 F. 2d 836 (2d Cir. 1968).

PENN CENTRAL* and had concluded that it was creditworthy by GS' standards:

"A. I relied on Goldman, Sachs completely for quality paper." [Tr. 67, 67a].

"THE COURT: And fifth, although you didn't specifically know whether they [GS] had made an investigation as to this particular [PENN CENTRAL'S] line of notes, you assumed they did?

[LEMAY]: That is correct." [Tr. 67, 67a].

"THE COURT: Would it be too blunt to say that in your mind what was good enough for Goldman, Sachs was good enough for you to pass on to your customers?

[LEMAY]: You are absolutely right, Judge."
[Tr. 68, 68a].

The further inference is therefore justified that the FOUNDATION would not have purchased the PENN CENTRAL commercial paper if GS had been truthful and informed LEMAY that it had not conducted a reasonable credit investigation or that the credit investigation it had conducted was inadequate. Accordingly, "but for" the misrepresentation of GS, the FOUNDATION would not have purchased the PENN CENTRAL commercial paper from GS. The requisite causation between the misrepresentation and the sale or damage to the FOUNDATION was consequently established. The misrepresentation was "instrumental" in the FOUNDATION'S purchase of the PENN CENTRAL commercial paper from GS.

Accordingly, the argument of GS that the FOUNDATION can not recover under §12(2) because no causal relationship exists

* Even without LEMAY's assumption, GS represented as a matter of law that an adequate and reasonable credit investigation had been performed. POINT I, supra.

between the failure of GS to perform its duty of investigation and damage to the FOUNDATION is without merit.* Furthermore, even assuming that GS would not have learned any additional adverse information with respect to PENN CENTRAL if it had performed an adequate credit investigation**, such a conclusion is not only irrelevant to the issue of causation but contrary to the legislative purpose of the securities laws.

Thus, in DeMarco v. Edens, 390 F. 2d 836 (2d Cir. 1968), this Court held that the requisite causation under §12(2) existed in connection with the sale of stock pursuant to an offering circular which contained a material omission notwithstanding the fact that the sale was consummated before the plaintiff received the offering circular.

"We also note our agreement with the district court's rejection of appellees' argument, that, as the offering circulars to which the omission in question was ascribed were not received by the appellants until their confirmations of sale were received (i.e., after the sale had been completed), the sale was not 'by means' of the circular. Were we to support appellees' contention we would, in effect, be erroneously introducing an element of reliance into the construction of Section 12(2)." 390 F. 2d at 841 (citations omitted).

The relevant fact in DeMarco with respect to causation was that a material omission was made in the course of the sale of a security.

By parity of reasoning, the only fact which is relevant to the issue of causation in the instant case is that GS made a material misrep-

*Thus, in Franklin, under the same facts and circumstances presented herein, this Court apparently concluded that causation had been established since the only issue on remand was whether it was "...reasonable for it [GS] to have determined on March 16, 1970 that the quality of the [PENN CENTRAL] paper it [GS] was purveying was less than that represented." Franklin at 527.

**See POINT III(B), infra.

resentation to the FOUNDATION in connection with its purchase of PENN CENTRAL commercial paper.* What GS would have learned had there been no misrepresentation (or an adequate credit investigation) is irrelevant. Likewise, in Eagle v. Horvath, 241 F. Supp. 341 (S.D.N.Y. 1965), causation pursuant to §14(a) of the 1934 Act was found to exist notwithstanding that the transaction in issue could have been effected without the votes of the minority shareholders who received misleading proxy statements.

"There is one glaring fallacy in defendant's argument: the mere unexercised power to redeem the issued and outstanding shares of preferred stock cannot be equated with the exercise of that power which, had it been exercised, would have given defendants more than the requisite two thirds vote of the only then remaining class of stock issued and outstanding--the common stock.

Because the power was not exercised, there was, at the time the allegedly false proxy statements were acted upon, a class of persons--the preferred shareholders--through whom Mount Clemens was injured.

* * *

Defendants cannot accomplish by deception what they might have accomplished honestly and then be heard to say that the deception was not the cause. Lawsuits are determined by what was and not what might have been." 241 F. Supp. at 343-344.

Finally, in TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976), the Supreme Court held:

"The general standard of materiality that we think best comports with the policies of Rule 14a-9 is as follows: an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how

* See Chasins v. Smith, Barney & Co., supra at 1172, wherein the Court held there was sufficient causation when a broker failed to reveal it was a market maker in the stock sold to plaintiff because it deprived plaintiff of the opportunity "to question the reasons for the recommendation" of the maker. The plaintiff was not required to show that had he questioned the reason for the broker's recommendation, he would not have purchased the stock.

to vote. This standard is fully consistent with Mills' general description of materiality as a requirement that 'the defect have a significant propensity to affect the voting process.' It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote."

To adopt GS' arguments would also undermine the philosophical intent of the securities laws to encourage high ethical standards in the securities industry and full disclosure of material facts to investors*. Thus, in Mills v. Electric Auto Lite Co., 396 U.S. 375 (1970), the Supreme Court disregarded a technical argument regarding causation pursuant to §14(a) of the 1934 Act and subordinated it to the paramount interest of a shareholder being adequately informed regarding a securities transaction**:

"Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and injury for which he seeks redress if, as here,

*"...The fundamental purpose, common to these [1933 and 1934] statutes was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry...' it requires but little appreciation...of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail in every facet of the securities industry'". SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186-187 (1963) (citation and footnotes omitted) (emphasis supplied). "...Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes'". Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972). **In addition, the Court indicated (396 U.S. at 386, n.7), although it did not hold, that it was unnecessary to consider what would have occurred in the absence of a misleading proxy solicitation (or if it were concluded that the transaction could have been approved regardless of the votes of the defrauded shareholders) since causation would be established by the mere fact of the (necessity for the) existence of the proxy solicitation.

he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction. This objective test will avoid the impracticalities of determining how many votes were affected, and, by resolving doubts in favor of those the statute is designed to protect, will effectuate the congressional policy of ensuring that the shareholders are able to make an informed choice when they are consulted on corporation transactions." 396 U.S. at 385 (citations omitted).

In order to insure a high standard of ethics in the securities industry and informed decisions in the securities market, a defendant should not be permitted to claim that its violation of the securities laws was irrelevant to the plaintiff's damage if the act contributed to such damage. It is therefore submitted that to adopt the causative standard formulated by GS would be tantamount to causing a philosophical regression of the securities laws, replacing good faith, full disclosure with its antecedent of "caveat emptor". Such an approach would impose an unreasonable burden of proof on a defrauded purchaser/seller and enable brokers, dealers and underwriters to elude liability for failing to perform the duties with which they are statutorily charged. Under the instant facts, by offering the PENN CENTRAL commercial paper, GS was charged with conducting a reasonable credit investigation of PENN CENTRAL. It failed to discharge the duty and thereby misrepresented a material fact to the FOUNDATION in the absence of which the FOUNDATION would not have made its purchase. GS should not now be able to avoid liability for the loss resulting from its sale to the FOUNDATION by claiming there was no "causal nexus" between the deceptive representation upon which the sale was predicated and the sale.

B. IF THE FOUNDATION HAS THE BURDEN OF SHOWING THAT AN ADEQUATE CREDIT INVESTIGATION BY GS WOULD HAVE REVEALED INFORMATION THAT WOULD BE SIGNIFICANT TO GS IN CONNECTION WITH GS' OPINION THAT PENN CENTRAL WAS CREDITWORTHY, IT HAS SATISFIED THAT BURDEN

It is undisputed that PX-101, 102 and 103 [1785a, 1790a, 1795a] were documents in PENN CENTRAL'S files containing material information about PENN CENTRAL that should have caused GS to change its opinion of PENN CENTRAL'S creditworthiness. GS does not challenge the District Court's characterization of PX-101-103:

"Had the defendant requested copies of the Company's projected first quarter earnings as they were revised on a bi-weekly basis it would have seen that from mid-February through early March the enormity of the first quarter results was foreseen. (Plaintiff's Exhibit 101-103)." 422 F. Supp. at 904.

Thus, GS' only argument with respect to causation is the availability and admissibility of PX-101-103.* As demonstrated below, PX-101-103 were available to GS and were properly admitted in evidence either under appropriate exceptions to the hearsay rule or because they were offered for non-hearsay purposes. It will also be shown that if GS had conducted a reasonable credit investigation, it would have discovered that its assumption that PENN CENTRAL had adequate contingency plans was incorrect. Finally, it will be shown that no matter what GS might have discover-

* At page 52 of its Brief, GS apparently asserts that the District Court clearly erred in finding GS could have learned that PENN CENTRAL'S "single largest lender had declined to participate in" the \$50,000,000 bridge loan because the only support for this finding is PX-106 [1799a] which was improperly admitted in evidence. This contention is belied by the additional support for this finding of fact cited in the opinion. 422 F. Supp. at 904. See, in particular, DX-AD, 1884a.

ed if it had conducted a reasonable credit investigation, it still would not have changed its opinion regarding PENN CENTRAL'S credit-worthiness.

1. PX-101-103 COULD HAVE BEEN OBTAINED FROM PENN CENTRAL

The District Court's finding that:

"There is no reason to doubt that the Company would have provided this kind of information to Goldman, Sachs at this juncture in view of its dependence on the commercial paper market, and in turn, on Goldman, Sachs, for survival until long-term financing could be arranged" (422 F. Supp. at 904),

is amply supported by the record.* Thus, while WILSON testified he did not ask for such documents because he saw no need for them, he nevertheless believed they would have been produced upon request:

"THE COURT: Let me ask this: Did you ever have any reason to believe in the course of your dealings with Penn Central that if you had asked them for any document or material, reasonably necessary for purposes that you were responsible for, that they would refuse to give it to you?

[WILSON]: I do not believe so, no." [Tr. 995-996, 995a].

Similarly, LEVY, GS' primary contact with PENN CENTRAL, testified that to the best of his knowledge, PENN CENTRAL never denied a request for information from GS [Tr. 816-817, 816a] and BEVAN testified:

"Q. Did you ever refuse any requests for information put to you by Goldman, Sachs?

*If PENN CENTRAL had refused to provide any information requested by GS, GS had a duty to refrain from selling. Slade v. Shearson Hammill & Co., Inc., 517 F. 2d 398 (2d Cir. 1974).

A. I cannot answer that question. I have refused many, many times to give any number of people information when I didn't think under SEC regulations would be proper to do. I don't remember any improper requests, and I don't remember any refusals for Goldman, Sachs, but I have refused many people because I thought it was inside information and I couldn't give it out." (emphasis supplied) [Bevan Deposition 172-173, 1139a].

Despite the foregoing testimony of WILSON, LEVY and BEVAN, GS claims that the District Court's finding of fact (422 F. Supp. at 904) was clearly erroneous by relying on the testimony of BEVAN [Bevan Deposition 213-214, 1143a]. GS Brief, p.42. The quoted testimony of BEVAN establishes two facts: (1) PENN CENTRAL would not give "its budget to its stockholders" and (2) if GS had requested PENN CENTRAL'S budget, BEVAN was "quite sure" his legal department "would say it was inside information". It is unnecessary to examine the validity of these factual contentions (or the admissibility of BEVAN'S speculations) because they are patently irrelevant since GS, as the underwriter and exclusive dealer of PENN CENTRAL'S commercial paper, was entitled (if not required) to receive inside information about PENN CENTRAL. Accordingly, it is clear that GS has failed to establish that the finding that PX-101-103 were available to it was clearly erroneous.

2. PX-101-103 WERE PROPERLY
ADMITTED IN EVIDENCE

PX-101-103 were properly admitted into evidence and GS' authentication and hearsay objections are without merit.

(a) PX-101-103 WERE PROPERLY AUTHENTICATED
AND IN ANY EVENT GS WAIVED ANY OBJECTION
AS TO AUTHENTICITY

When the FOUNDATION offered PX-101-103 in evidence on the second day of trial, GS objected:

"We are not pressing authentication as such, based on that [ASAY'S] testimony. We do argue that the documents are not established to be business records." [Tr. 204, 204a].

The documents were then admitted in evidence. At the conclusion of its case during the last day of trial, GS moved to strike certain exhibits which had been admitted in evidence, including PX-101-103 [Tr. 1053, 1053a]. In connection with this motion, the following discussion occurred between the Court and GS' counsel:

"MR. MANEY: My motion to strike was not based on authentication. It is based on the fact it is hearsay, unexplained, not a business record and these documents which appear to be railroad documents have not been explained subsequently.

THE COURT: Can you give me an example of one? There are so many. Can you give me an example of one which has been received for the purposes of establishing the truth of its contents?

MR. MANEY: 101, 102 and 103, Your Honor."
(emphasis supplied) [Tr. 1056, 1056a].

It is therefore clear that GS has waived any authenticity objection it might have had to PX-101-103.* See Fed. R. Evid. 103(a) (1) and Shaw v. U.S., 403 F. 2d 528, 530 (8th Cir. 1968), wherein the Court stated, "barring plain error, we will not notice errors raised for the first time in the appellate court, including errors involving a defendant's constitutional right." (citations omitted). In any event, the authenticity of PX-101-102 was established, infra.

* Indeed, MR. MANEY stated PX-103 had been admitted into evidence [Tr. 895, 895a].

(b) PX-101-103 ARE BUSINESS RECORDS

GS contends that PX-101-103 are not business records under Fed. R. Evid. 803(6) because the FOUNDATION did not establish the following "element" of that Rule that "it was the regular practice of that business activity to make the memorandum..." GS Brief, p. 45. On the contrary, the FOUNDATION satisfied this element of Rule 803(6) by submitting the testimony of THOMAS P. ASAY, the then custodian of PENN CENTRAL'S records. ASAY testified that UNDERHILL, the author of the financial projections, was an employee who worked in PENN CENTRAL'S "financial department" [Asay Franklin (DC) Tr. 78, 1068a], that he originally located PX-101-103 in a file with other similar documents that came to him "from the office of the chairman of the board" (SAUNDERS) in the course of the SEC'S investigation of PENN CENTRAL, that the signature on the projections "appeared" to be UNDERHILL'S [Id. at 78-79, 1068a] and that:

"Q. The enclosures appear to be projections for earnings for the first quarter earnings. Did you find similar projections for other quarters of the other Penn Central companies in its files?

A. There appear to be documents of this nature in the file, although I haven't examined them from a study standpoint.

Q. For periods prior to February 1970?

A. Yes.

Q. You found those, did you not?

A. Yes.

Q. Are they of a similar nature to these three [PX-101-103] that I am holding in my hand?

A. They appear to be similar,
[Asay Franklin (DC) Tr. 81-82, 1071a].

Based on the foregoing testimony, the trial court in Franklin (DC)

admitted PX-101-103 in evidence over GS' objections of relevancy and authentication [Id. at 84,1074a]. Apart from ASAY'S testimony that the files of the PENN CENTRAL Chairman of the Board contain other "documents of this nature" (i.e., financial projections for other quarters) for "periods prior to February 1970", the documents themselves establish it was the regular practice of PENN CENTRAL to prepare such documents. Thus, each of the projections, although covering a different period of time and prepared for a different meeting, are on identical printed forms containing identical categories next to which are blanks to be filled in with the relevant financial or statistical data. See U.S. v. Ragano, 520 F. 2d 1191 (5th Cir. 1975), where the Court upheld the admission into evidence under the Federal Business Records As Evidence Act (28 U.S.C. §1732) of documents of a company even though it had not been shown that it was the regular practice of the company to make such documents:

"The failure by the government to lay foundation, in the form of testimony by an employee of Two Seasons as to the procedure used in preparing and filing these documents does not affect their admissibility, in light of the stipulation as to their authenticity[*] and the fact that they were filed and prepared in the regular course of business." 520 F. 2d at 1200 (citations omitted),

and U.S. v. Tellier, 255 F. 2d 441 (2d Cir. 1958), cert. denied, 358 U.S. 821(1958). In Tellier, this Court held that if a "defendant has made representations concerning the financial condition of a corporation, the books of that corporation are competent as evidence against him..." (255 F. 2d at 448). Similarly,

*Here, any objection as to authenticity has been waived and GS has not asserted the documents were not prepared in the regular course of PENN CENTRAL'S business.

it would appear that the books and records of PENN CENTRAL are competent as evidence against GS to establish the falsity of GS' representation that PENN CENTRAL was creditworthy.

Under Fed. R. Evid. 201, this Court may take judicial notice of the fact that companies like PENN CENTRAL have a regular practice of making financial projections.

"Nevertheless, judicial notice of the nature of the business and the nature of the records as observed by the Court are often enough to provide a foundation for admissibility. This is particularly true of banks and similar statements." 4 Weinstein's Evidence ¶803(6) [02] at 803-143.

In this connection see Carrol v. U.S., 326 F. 2d 72, 77 (9th Cir. 1963), where the Court held that records were admissible under 28 U.S.C. §1732 despite a contention that they were not made in the regular course of business:

"Our examination of these records indicates that they were obviously kept in the regular course of business and that they certainly were not later created by some minion of the government for the purpose of convicting these appellants.

* * *

These documents themselves show what they purport to be, i.e. records of purchases... during the period in question."

See also U.S. v. Quong, 303 F. 2d 499 (6th Cir. 1962), cert. denied, 371 U.S. 863 (1962).

Judge Weinstein notes that the "regular practice" element of Rule 803(6) upon which GS totally relies was not usually stressed by the federal courts except when the court was concerned

with the trustworthiness of the record:

"Under previous practice numerous courts stated in dicta that the Federal Business Records Act required not only that the record be made in the ordinary course of business, but also that it was the regular course of business to make that particular type of record. A reading of the cases indicates that this second factor was not usually stressed. Records were customarily admitted if made in the course of business without regard to whether the particular type of record was routinely made, except when the court was concerned with the trustworthiness of the record. Then, as in the leading case of Palmer v. Hoffman, the court might say that the record was not typical of entries made systematically or as a matter of routine to record events or occurrences, to reflect transactions with others, or to provide internal controls. Rule 803(6) should be interpreted so that the absence of routineness without more is not sufficiently significant to require exclusion of the record. (Footnotes containing cases cited therein omitted) 4 Weinstein's Evidence ¶803(6) [01] at 803-145.

There is no reason to doubt the trustworthiness* of these documents since GS admits they came from the files of PENN CENTRAL. GS Brief, p. 43. GS has not offered any evidence that these documents are forgeries** or that anyone had a reason or motive to falsify such documents. The financial projections involved on their face, nine PENN CENTRAL employees. Despite the availability of those nine employees to testify to the lack of trust-

*A lack of trustworthiness as used in connection with Rules 803(6) and 803(24) generally refers to a motive to falsify or misrepresent. See 4 Weinstein's Evidence ¶¶803(6)[05] and 803(24) and cases cited therein.

**When GS objected to a PENN CENTRAL document (PX-110 for identification) on grounds of untrustworthiness because BEVAN claimed his initials on the document were forged, the District Court sustained the objection [Tr. 213-214, 213a]: "I ruled against Mr. Breindel once before when you [GS counsel] said there was some evidence that Mr. Bevan had stated something was a forgery..." [Tr. 1055, 1055a].

worthiness of the financial projections, GS can only offer the self-serving testimony of the discredited* BEVAN. BEVAN did not deny receiving the projections but merely testified that he did not "know whether" he "did" [Bevan Deposition 170,1137a] and that he had "no recollection" and "they are not in what I remember as the regular form". [Id. at 172,1139a]. Under these circumstances the language of the Court in Dallas County v. Commercial Union Assurance Co., 286 F. 2d 388, 397 (5th Cir. 1961), is particularly appropriate: "There is no procedural canon against the exercise of common sense in deciding the admissibility of hearsay evidence."

Furthermore, in view of the trustworthiness of PX-101-103

*The following references in his opinion indicate the District Court's disbelief of BEVAN in particular and PENN CENTRAL management in general: GS' "failure to inquire more closely into the basis for the statements of Bevan and O'Herron at the February 6th meeting" (422 F. Supp. at 902); GS' "repeated claim that ... it had no reason to doubt the ... candor of Company management... is not supported by the record...The lack of candor was not limited to the sparring over banklines, moreover... ."Id. at 903. From the following testimony, it appears that LEVY also lost faith in BEVAN and SAUNDERS:

"Q. Do you know the post-bankruptcy position of Mr. Saunders and Mr. Bevan?

A. I do not.

Q. Do you still have the same opinion of them as you did when you were selling their paper?

A. That's a tough question. Obviously I don't think they are as smart as they were and some things were brought out, you know, that doesn't look good for them, so I can't honestly say I do. Yes, my opinion is somewhat changed." [Tr. 809-810, 809a].

as is demonstrated, supra, and their conceded materiality, these documents also qualify as an exception to the hearsay rule under Fed. R. Evid. 803(24). Muncie Aviation Corp. v. Party Doll Fleet, Inc., 519 F. 2d 1178 (5th Cir. 1975).

- (c) EVEN IF PX-101-103 WERE HEARSAY, THEY NEVERTHELESS ESTABLISH THAT HAD GS BEEN AWARE OF THEIR CONTENTS, IT WOULD BE SIGNIFICANT TO GS IN CONNECTION WITH ITS OPINION THAT PENN CENTRAL WAS CREDITWORTHY

Even if PX-101-103 are not admissible to prove the truth of their contents, they are admissible to show that if GS was aware of such information (whether it was true or not, i.e. if PENN CENTRAL'S state of mind was one of expectation of large losses for the first quarter of 1970), it would have been significant to GS in connection with its opinion of PENN CENTRAL'S creditworthiness or it would have caused GS to do a more thorough investigation. Thus, in offering these documents, the FOUNDATION asserted:

"MR. ATLAS: As was made clear through the testimony of Mr. Asay and Mr. Sullivan, we offer them to establish what Goldman, Sachs could have and should have obtained, what kind of information they could have been made aware of if they had made a reasonable credit investigation, if they had made any inquiry whatsoever.

It is true they are just projections, but the point is, it is what they possibly would have led to.

Goldman, Sachs could have easily determined that they were accurate, inaccurate, whatever. The point is that they should have made an effort to have that information. Whether or not the projections of Mr. Underhill are accurate or not--" [Tr. 205, 205a].

The District Court clearly realized this when, in denying GS motion to strike PX-101-103, it stated:

"THE COURT: I don't know that they were offered for the purpose of establishing the truth of contents, but for the purpose of establishing that Mr., whatever it is, of Penn Central was giving this information to Mr. Bevan.

MR. ATLAS: Exactly, Mr. Underhill was giving the information to Mr. Bevan.

THE COURT: I can see that it does or at least it is reasonable to permit the plaintiffs to argue that there was more information available to Mr. Wilson than he attempted to secure. It seems to me that your case stands and falls on whether, in any event, the information he did secure was adequate to fulfill his legal obligations. But, I don't see why defendant should be foreclosed from attempting to establish that other information existed. You may well argue it existed, or it was meaningless or -- Mr. Wilson himself testified whether he got it or not, he wasn't paying much attention to it." [Tr. 1056-1057, 1056a].

C. A REASONABLE CREDIT INVESTIGATION WOULD HAVE REVEALED TO GS THAT PENN CENTRAL LACKED "ADEQUATE CONTINGENCY PLANNING"

WILSON testified that PENN CENTRAL failed despite "ample resources" because it did not have adequate contingent plans to raise cash for working capital needs and that the bankruptcy was "a classic example where the management of a major corporation blundered" [Tr. 934-938, 934a]:

"We even had discussed some of the alternative plans that the management could use to raise cash, to supplement its working capital during this period of time, and they're in the blue sheets.

* * *

So to me it was a question of having the assets -- I think this is what the banks viewed and certainly what we viewed -- and the blunder in

all this is as they went through in the early part of 1970, they evidently ran into a lot of circumstances they either hadn't foreseen or hadn't planned on.

* * *

So my answer is, this is a managerial blunder, a classic one. Competent management that hadn't seen it or whatever and hadn't taken the time to think it through and to put some of the actions into plan so they would have the cash." [Tr. 935-937, 935a].

WILSON'S testimony and GS' failure to produce any evidence of adequate contingency planning by PENN CENTRAL establish that the following finding by the District Court is not clearly erroneous:

"Similarly if defense witnesses are correct that the bankruptcy was triggered by a lack of adequate contingency planning, inquiry would have revealed the situation." 422 F. Supp. at 904.

D. NOTHING WOULD HAVE CAUSED GS TO
CHANGE ITS UNREASONABLE OPINION
THAT PENN CENTRAL WAS CREDITWORTHY

GS' argument that a reasonable credit investigation would not have revealed any information that would have caused it to change its opinion that PENN CENTRAL was creditworthy is rendered meaningless by the fact that GS' management was so enamored of PENN CENTRAL'S management it would have (and did) ignored all objective indicia of PENN CENTRAL'S lack of creditworthiness*. Thus,
*VOGEL testified:

"Q. During the time GS was selling the Penn Central commercial paper, did you ever have any doubt as to the creditworthiness of Penn Central?

A. Absolutely none whatsoever." [Tr. 647, 647a].

GS continued to offer to sell PENN CENTRAL commercial paper right up until the bankruptcy although there came a time when people stopped buying. [Tr. 814-815, 814a]. As previously noted, GS blindly believed in the competency and integrity of PENN CENTRAL management throughout this period even though it disbelieved their contentions that PENN CENTRAL could not get additional banklines and despite the fact that it learned their ability to make financial projections was suspect. Further evidence of GS' blind faith in PENN CENTRAL is the fact that on February 5, 1970 VOGEL told ROGERS of NCO [PX-10, 1716a] that GS would continue to sell the PENN CENTRAL commercial paper despite the February 4, 1970 announcement of PENN CENTRAL'S losses even though it was not until the meeting with PENN CENTRAL on February 6, 1970 that "Levy and Wilson were satisfied with the explanation of the unexpected 4th quarter losses..." which they generally found surprising, unsettling and "bad news". 422 F. Supp. at 890. The situation is aptly characterized by the District Court:

"Throughout the case the defendant has argued that in the conduct of its ongoing credit review it simply never had reason to doubt the Company's viability. When queried by the court as to what kind of information he could have received which would have alerted him to the impending debacle, Wilson responded essentially that he could think of none because the Company had ample resources to raise cash up to the very end and management at all times spoke credibly and reassuringly of their options for reversing the downward trend. (937-38). In fact, defense witnesses maintained that Penn Central's collapse was a financially unnecessary event, caused by a failure of will or imagination on the part of management upon the government's unexpected refusal to extend a loan to the Company to cover

for the last-minute withdrawal of a large debenture offering (See 759-60). Necessarily implicit in this line of defense is the breath-taking proposition that so far as Goldman, Sachs could reasonably ascertain, the Company was actually creditworthy up to the bitter end. The argument proves too much. While our findings in no sense depend upon it, one may nevertheless fairly ask whether the defendant's procedures and standards for monitoring the creditworthiness of an issuer might not almost be said to be prima facie inadequate if it is possible that such a presumably sound company as Penn Central could go bankrupt without the prior knowledge of, or even without a hint to Goldman, Sachs, its exclusive dealer in commercial paper." 422 F. Supp. at 901.

It is therefore obvious that GS would have continued to sell the commercial paper of PENN CENTRAL regardless of any information a reasonable credit investigation would have revealed.*

*"Since it is uncertain precisely what information a reasonable investigation would have revealed, it is impossible to state whether Goldman, Sachs would have been liable under the latter theory had it adequately inquired and yet continued to market the paper. In view of the enormity of the continuing 1st quarter losses and the increasingly bleak market conditions for long-term financing (see Defendant's Exhibit FJ), however, a court might well conclude that a continued belief in the creditworthiness of the Company would have been unreasonable. Despite the defendant's efforts to minimize the significance of the huge losses, there is at least some testimony that they were indeed a significant cause of the Company's demise. (813)." 422 F. Supp. at 904, n.23.

POINT IV

THE DISTRICT COURT ERRED IN CONCLUDING THAT GS DID NOT HAVE A DUTY TO DISCLOSE MATERIAL FACTS

The District Court, relying on the case of Phillips v. Reynolds & Co., 297 F. Supp. 736 (E.D. Pa. 1969), declined to rule as to whether the omissions of GS, either individually or in the aggregate, constituted violations of §12(2) of the 1933 Act.* The lower Court's ruling was premised upon its characterization of the nature of the commercial paper market (wherein "there is little or no expectation of unsolicited disclosure of the numerous facts always available as to an issuer's condition", 422 F. Supp. at 895) and the fact that LEMAY did not seek factual information from GS (but rather only sought "a judgment of creditworthiness and chose to rely on it", Id.). To the District Court, these facts created "circumstances under which" the omissions "were made" (as that phrase is used in §12(2) of the 1933 Act) which excused GS from its duty to disclose material facts. As demonstrated below, the District Court's reliance upon Phillips is misplaced and GS had a duty to disclose the omitted facts to the FOUNDATION regardless of the nature of the commercial paper market or the fact that LEMAY did not seek information about PENN CENTRAL from GS.

A. GS HAD A DUTY TO DISCLOSE THE OMITTED FACTS

GS, as an underwriter of PENN CENTRAL commercial paper, as a possessor of inside information about PENN CENTRAL and as a

*It did, however, hold that "the omitted facts, of themselves" did not render GS' judgment "that the Company was creditworthy unreasonable". 422 F. Supp. at 895-896.

dealer in its paper had a duty to make full disclosure of all material facts about PENN CENTRAL to the FOUNDATION.

As the exclusive seller of PENN CENTRAL commercial paper, GS was an underwriter pursuant to §2(11) of the 1933 Act*. Sanders v. John Nuveen & Co. Inc., 524 F. 2d 1964 (7th Cir. 1975), vacated on other grounds and remanded, 425 U.S. 929 (1976). See also Mallinckrodt Chemical Works v. Goldman, Sachs & Co., 420 F. Supp. 231 (S.D.N.Y. 1976), referring to GS as the underwriter for PENN CENTRAL commercial paper. Because of its access to information about an issuer which is not available to the public and its relationship with its customers, an underwriter has a duty to disclose all material facts to its customers in connection with the sale of security. Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 495 F. 2d 228 (2d Cir. 1974); Sanders v. John Nuveen & Co., Inc., supra**; Chris-Craft Industries Inc. v. Piper Aircraft Corp., 480 F. 2d 341 (2nd Cir. 1973), cert. denied, 414 U.S. 910 (1973):

* §2(11) states, in pertinent part: "...the term 'underwriter' means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security..."

** The Sanders holding is based upon the general purpose of the federal securities laws, full disclosure to investors. See Feit v. Leasco Data Processing Equipment Corporation, 332 F. Supp. 544 (E.D.N.Y. 1971). Accordingly, there is no reason to confine the duty of a §2(11) underwriter to registration statements which contain misrepresentations and omissions. As the District Court noted:

"Moreover, both Sanders and Chris-Craft brought under Sections 14 and 10(b) of the 34 Act respectively, refute Goldman, Sachs' assertion that the status of the underwriter has significance in terms of civil liability only under Section 11." 422 F. Supp. at 900.

"The investing public properly relies upon the underwriter to check the accuracy of the statements and the soundness of the offer; when the underwriter does not speak out, the investor reasonably assumes that there are no undisclosed material deficiencies." 480 F. 2d at 730 (emphasis supplied).

Similarly, as the possessor of material inside information about PENN CENTRAL, GS had a duty to:

"Either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such information remains undisclosed." SEC v. Texas Gulf Sulphur Co. 401 F. 2d 833, 848 (2d Cir. 1968); cert. den. sub. nom., Coates v. Sec., 394 U.S. 976 (1968).

See also Slade v. Shearson, Hammill & Co., Inc., (CCH) Fed. Sec. L. Rep. ¶94,329 (S.D.N.Y. 1973); Chris-Craft Industries v. Bangor Punta Corp., (CCH) Fed. Sec. L. Rep. ¶93,813 (2d Cir. 1973); Speed v. Transamerica Corp., 99 F. Supp. 808 (D.Del. 1951) and Radiation Dynamics, Inc. v. Goldmuntz, 464 F. 2d 876 (2d Cir. 1972).

Finally, GS' role as a dealer* in PENN CENTRAL commercial paper required it to make full disclosure of all material facts to the FOUNDATION regarding the commercial paper. As stated in Wohl v. Blair & Co., 50 F.R.D. 89, 91 (S.D.N.Y. 1970):

"The first of these policies (inherent in the antifraud provision of the securities acts) is that of full disclosure by a securities dealer who recommends a transaction, which imposes a duty upon him to have an adequate basis for the recommendation and to disclose to his

*See Hanly v. SEC, supra.

customer, toward whom he acts in the position of a fiduciary, all facts known or reasonably ascertainable to the customer's purchase." (citation omitted).

In view of the foregoing, GS was required to disclose all material facts to the FOUNDATION as a prospective purchaser of PENN CENTRAL commercial paper. Moreover, the duty to disclose is not dependent upon the sophistication or knowledge of the particular investor. "Sophisticated investors, like all others, are entitled to the truth". Stier v. Smith, 473 F. 2d 1205, 1207 (5th Cir. 1973); Lehigh Valley Trust Co. v. Central National Bank of Jacksonville, 409 F. 2d 989 (5th Cir. 1969). In addition, a willingness to disclose is not the equivalent of disclosing nor does the availability of the relevant information elsewhere excuse non-disclosure. Id., Gilbert v. Nixon, 429 F. 2d 348 (10th Cir. 1970); Hill York Corp. v. American International Franchises, Inc., 448 F. 2d 680 (5th Cir. 1971).

In concluding that the nature of the commercial paper market created an exception to GS' duty to disclose material facts to the FOUNDATION, the District Court cited no authority in support of its conclusion*. Indeed, there is only authority to the

*In this connection, it should be noted that Judge Brieant stated at page 3,135 of the trial transcript of Welch Foods, Inc. v. Goldman, Sachs & Co.:

"The Court: Most of the facts, perhaps all of them, which he [Plaintiffs' counsel] relies on as omitted facts are so simple that really you know, they could have been given. Maybe we are addressing this problem with hindsight and perhaps we shouldn't. But most of the facts could have been compressed into one half a sentence. The sentence could have been 'We think these are prime quality and just as good as anything else we have in our house but you ought to know such-and-such a fact.'"

contrary. See Sanders v. John Nuveen & Co., Inc., supra*, and Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 495 F. 2d 228 (2d Cir. 1974).

In Shapiro, defendant Merrill, Lynch as the prospective managing underwriter of a proposed offering of Douglas Aircraft debentures learned of adverse, non-public, material financial information about Douglas which it disclosed to certain of its customers. The customer-defendants then sold their shares of Douglas common stock on the open market before the adverse information was announced by Douglas to the public. Plaintiffs who purchased shares of Douglas on the open market at that time did "not claim to have purchased specific shares of Douglas stock sold by any of the selling defendants". Plaintiffs' claims were grounded upon the argument that "defendants were under a duty to disclose to the general public, including plaintiffs, the material inside information regarding Douglas' earnings..." 495 F. 2d at 228. Defendants contended that purchasers of Douglas stock "who did not purchase the actual stock sold by defendants" (495 F. 2d at 236) were excepted from defendants' duty to disclose material inside information (just as GS here contends that commercial paper investors are excepted from its duty to disclose material inside information). In rejecting this contention, the Court noted:

"As the author recognizes, 'Since in any active market disclosure to a particular

* In its opinion the District Court noted that the Hochfelder case "casts serious doubt" on Sanders as a precedent under Rule 10b-5 but that Sanders "retains relevance" with respect to claims under §12(2) of the 1933 Act. 422 F. Supp. at 900. In its brief on remand from the United States Supreme Court, Appellee Sanders is seeking affirmance of the District Court's opinion under §12(2) as well as 10b-5 on the ground that the conclusions of law of the Court expressed a violation of §12(2).

individual is not feasible, the duty to disclose, if such a duty exists, must be owed to all members of that ill-defined class of stockholders who, with the benefit of inside information, would alter their intention to [buy].¹ Painter, 65 Colum. L. Rev. at 1378." 495 F. 2d at 236, n. 14.

Since the possessor of material inside information about an issuer has a duty to abstain from trading the securities of that issuer or to disclose adverse material information to investors who purchase such securities on the open market, because GS possessed material adverse information about PENN CENTRAL, it had a duty to disclose such information to the FOUNDATION in connection with the latter's purchase of commercial paper.

In support of the holding that LEMAY'S reliance on GS for its judgment as to the creditworthiness of PENN CENTRAL and LEMAY'S failure to seek additional information from GS relieved GS from its duty to disclose material facts, the District Court relies solely upon the questionable authority* of Phillips v. Reynolds & Co., supra (hereinafter "Phillips"), wherein a motion for reargument of the Court's earlier decision in Phillips v. Reynolds & Co., 294 F. Supp. 1249 (E.D. Pa. 1969) ("Phillips I"), was denied. Phillips, however, is patently distinguishable from the instant case. In Phillips, plaintiff Fish was a regular customer of defendant Warren, a registered representative of defendant Reynolds & Co. Fish, through Warren, purchased the "speculative" stock of Strategic Materials Corporation, a company which was running a deficit of approximately \$9 million. Thereafter, the stock

* The District Court appears to be the only court which has ever relied upon Phillips to excuse a duty to disclose.

declined in value and Fish brought an action to recover damages.

"The only major contention advanced by the plaintiff, Fish, at argument was that under Rule 10b-5 or under the common law of fraud, Warren had an affirmative obligation to inform him before purchasing that Strategic was running a deficit of approximately \$9 million." 297 F. Supp. at 737.

Although Fish also contended that he was not interested in speculative stocks and Warren knew this, the Court did not believe him because of his past history of "numerous speculative transactions" with Warren. After noting that:

"Fish himself admitted that Warren told him that Strategic's prospects rested on successful development of an experimental process, that it was a new company which did not pay a dividend, and that it was possible that Strategic might go from thirty to fifty within six months" (297 F. Supp. at 738),

the Court concluded that:

"Knowing these and other facts Fish must have been aware that Strategic was a speculative purchase.

* * *

Moreover, we think that this information was sufficient to apprise Fish of the general speculative nature of the investment which he perhaps overhastily undertook." 297 F. Supp. at 738.

The Court further stated that:

"Warren was not an 'insider' at the time of the transactions complained of; nor was he in possession of any information not generally available to investors who desired it." 297 F. Supp. at 738.

In this context, the Court, quoting from its decision in Phillips I, held:

"To make a broker liable under these circumstances would make him a virtual

insurer of his investment recommendations unless he provided customers with every conceivable material fact concerning a stock before customers purchased." 297 F. Supp. at 738.*

Accordingly, it is obvious that the holding in Phillips is not applicable to the facts at bar. GS, unlike Warren, was the underwriter and exclusive dealer of the securities in issue and was an "insider" in possession of information not "generally available" to the public. Fish, unlike the FOUNDATION, was generally aware of the material fact allegedly not disclosed, i.e., that the stock was speculative. Warren supported the opinion he gave Fish regarding the stock by his own purchase of "about 9,000 shares of Strategic stock for himself at a cost of \$229,000" which he subsequently sold at "a loss of \$173,598" (297 F. Supp. at 738). In contrast, GS predicated its representation to the FOUNDATION that PENN CENTRAL was creditworthy on March 13, 1970 on the following conduct, inter alia, in early February 1970: (1) GS required PENN CENTRAL to buy back \$10,000,000 of GS' \$15,000,000 inventory of PENN CENTRAL paper; (2) GS placed a \$5,000,000 limit on its inventory of PENN

* This quote was set forth in the District Court's opinion. 422 F. Supp. at 895. However, in Phillips I, the Court made it clear that the "circumstances" it was referring to was the fact that Warren was not in possession of non-public information:

"Warren was neither an insider at the time of the sales complained of, nor was he in possession of information which was not generally available to the plaintiffs had they sought it out. To make a broker liable under these circumstances would make him a virtual insurer of his investment recommendations unless he provided customers with every conceivable material fact concerning a stock before customers purchased. Under other circumstances a broker might well be liable under Rule 10b-5 but we think it is clear that he should not be so held here." 294 F. Supp. at 1,255.

CENTRAL paper; and (3) GS required PENN CENTRAL to have bank lines available to buy any portion of GS' inventory of unsold PENN CENTRAL paper which GS demanded be repurchased by PENN CENTRAL, thereby permitting GS to sell the paper on a risk-free basis. Finally, it appears that the Court in Phillips determined that there could not be a violation of Rule 10b-5 because the requirement of scienter was lacking. Such a determination has no relevance to the FOUNDATION'S claim under §12(2) which does not require scienter. It is therefore submitted that the District Court erroneously relied upon the inapposite case of Phillips, the only authority which purportedly contradicts the otherwise unanimous proposition that GS had a duty to disclose material facts to the FOUNDATION notwithstanding the "nature of the commercial paper market".

B. THE FACTS WHICH GS FAILED TO DISCLOSE WERE MATERIAL

The applicable objective test for determining the materiality of an omitted fact in a Rule 10b-5 case was set forth by the Supreme Court in Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-154 (1972)*:

"All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of his decision." (emphasis supplied).

In the recent decision in TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976), the Supreme Court set forth the following test of materiality under Rule 14a-9 of the 1934 Act:

* Although Affiliated Ute was decided in the context of a §10(b) claim, because the evidentiary burdens of proof are less stringent in a §12(2) case, if a fact is material for purposes of §10(b), a fortiori, it is material in connection with §12(2). See Franklin at 529.

"[A]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote... It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." 426 U.S. at 449 (emphasis supplied).

In any event, this Court need not determine whether the Affiliated Ute "might have" test or the TSC "would have" test is controlling because, as indicated hereinafter, each of the facts which GS omitted to disclose, infra, satisfy either criterion of materiality. Moreover, when the omissions are considered in the aggregate, irrespective of the separate materiality of each, the collective omissions of GS were clearly material under the foregoing tests as indicated by the District Court's finding that each omission was "relevant to a judgment of creditworthiness..." 422 F. Supp. at 896.*

* In this connection, as previously noted, the District Court did not expressly rule upon the materiality of the individual facts which GS failed to disclose. It merely held that "...none of them singularly or in the aggregate can be said to be necessarily conclusive of the judgment [of the creditworthiness by GS]." 422 F. Supp. at 896. It is therefore proper for this Court to review the extensive and essentially undisputed record presented herein and to conclude that one or more of the omissions, or the omissions in the aggregate, were material. Berko v. SEC, 297 F. 2d 116 (2d Cir. 1961); Janzen v. Goos, 302 F. 2d 421 (8th Cir. 1962); Hurwitz v. Hurwitz, 136 F. 2d 796 (D.C. Cir. 1943); United States v. Pendergast, 241 F. 2d 687 (4th Cir. 1957); and Estate of Hooper v. Government of the Virgin Islands, 427 F. 2d 45 (3rd Cir. 1970).

1. THE INVENTORY OMISSIONS

On February 4, 1970, PENN CENTRAL announced its preliminary losses for 1969, including its fourth quarter losses. In a telephone conversation on February 5, 1970, WILSON asked O'HERRON to have PENN CENTRAL repurchase \$10,000,000 of the \$15,000,000 in PENN CENTRAL commercial paper which GS had in inventory and O'HERRON agreed to do so on February 9, 1970 [PX-11,1717a]. On February 9, 1970, PENN CENTRAL repurchased the \$10,000,000 of commercial paper from GS by utilizing its existing bank lines of credit [PX-12,1719a]. In conjunction with the repurchase, GS imposed a \$5,000,000 inventory limit or ceiling with respect to PENN CENTRAL commercial paper [PX-12,1719a] "until such time as they [PENN CENTRAL] obtained 100% line coverage, completed some of these long-term financings, and started to reduce operating losses" [PX-14,1722a]. The resale by GS to an issuer of its inventory simultaneously with the imposition of an inventory limit was unprecedented in GS' history as a commercial paper dealer since 1869. 422 F. Supp. at 884. Indeed, an inventory limit had never been placed on an industrial* issuer such as PENN CENTRAL prior to this time [Tr. 819,819a ; Van Cleave Deposition 185-186, 1211a ; Lynch Deposition 41,1198a]**. Furthermore, based on the February 6, 1970 meeting with GS and PENN CENTRAL and conversations between PENN CENTRAL and GS at or about the time of the meetings, it was understood by both GS and PENN CENTRAL that after the repurchase of the \$10,000,000 of inventory:

(a) PENN CENTRAL'S "backup lines...
[would] be made available to cover

* As opposed to a finance company.

** See DX-BM [1887a] and Tr. 725 [725a].

runoffs for maturities in excess of what they [PENN CENTRAL] don't sell plus our [GS'] \$5mm position" [PX-12, 1719a] (emphasis supplied).*

(b) GS would sell PENN CENTRAL'S "paper only on a 'tap' issue basis where...[GS] did not inventory their notes..." [PX-11, 1717a].**

The uncontroverted testimony of LEMAY at trial established that none of the foregoing facts with respect to inventory reduction and limitation were disclosed to LEMAY [Tr. 35, 35a] and that if they had been disclosed he "would not have shown the paper" to the FOUNDATION [Tr. 35, 35a]. Although LEMAY'S testimony alone is sufficient to prove the materiality of the inventory omissions, in the context of the events which transpired thereafter***, their materiality cannot reasonably be questioned.

Moreover, the evidence establishes that GS itself considered the inventory omissions to be material. Thus, when WILSON proposed to have PENN CENTRAL repurchase \$10,000,000 of GS' inventory, supra, the response of O'HERRON was that:

"...he didn't think he wanted to do that [repurchase] today [February 5], as the New York banks he is going to see this afternoon to set up the additional \$50MM 5-month lines are the same ones he would have to contact today and he didn't feel this was very good strategy. I concurred with his reasoning." [PX-11, 1717a] (emphasis supplied).

* Accordingly, there would be no risk of loss to GS in inventorying the paper on this guaranteed basis.

** By selling the paper on a "tap issue" basis, as opposed to inventorying the paper, there was no risk of loss to GS. 422 F. Supp. at 888, n. 8.

***E.g., the inability of PENN CENTRAL to increase its bank lines despite GS' urgings; the dire financial straits of PENN CENTRAL in 1969 and 1970; the concern of NCO regarding PENN CENTRAL'S financial condition; the removal of PENN CENTRAL from the approved list of BROWN BROS.

The imprudence of indicating to the banks (from whom bank lines of credit were allegedly being sought) that on the day after its 1969 losses were announced PENN CENTRAL'S exclusive commercial paper dealer was substantially decreasing its PENN CENTRAL inventory is obvious. Accordingly, the WILSON-O'HERRON strategy was to not alert the banks of GS' concern for PENN CENTRAL'S financial condition and instead to have PENN CENTRAL repurchase its commercial paper after the banks had given (or refused as was the case) PENN CENTRAL additional bank lines. Therefore, for all intents and purposes, GS has admitted the significance or materiality of the inventory omissions by anticipating the adverse reaction of the banks to a disclosure of the inventory omissions. Likewise, VOGEL did not disclose GS' inventory reduction to ROGERS of NCO during their February 5, 1970 telephone conversation, presumably for the same reasons. As stated in SEC v. Shapiro, 349 F. Supp. 46, 54 (S.D.N.Y. 1972), aff'd., 494 F. 2d 1301 (2d Cir. 1974):

"Finally, and most convincingly defendants' own conduct illustrates the materiality of the information. A major fact in determining whether events are material is the importance attached to them by those who knew about them. Securities and Exch. Comm'n v. Texas Gulf Sulphur Co., supra, 401 F. 2d at 851. Here, the record reveals very significant juxtapositions between the timing of defendants' purchases and critical events in the negotiations."

Finally, this Court's decisions in Chasins v. Smith, Barney & Co., 438 F. 2d 1167 (2d Cir. 1970), and Dale v. Rosenfeld, 229 F. 2d 855 (2d Cir. 1956), clearly establish the materiality of the inventory omissions in view of GS' role as the underwriter and exclusive dealer for PENN CENTRAL commercial paper (which it sold as a principal) and the FOUNDATION'S reliance upon GS for its

"judgment" of PENN CENTRAL'S "creditworthiness"*. 422 F. Supp. at 886. These cases held that facts which pertain to the relationship between the company which recommends and sells a security and the issuer of that security are material to an investor who relies upon the company's recommendation of the security and the company's judgment of the issuer. In Chasins, the defendant broker-dealer recommended and sold certain over-the-counter stocks as principal to the plaintiff without disclosing that it was a market maker in such stocks. The issue posed by the Court was "whether disclosure of [defendant] Smith, Barney's being a market maker" in the stocks "might have influenced [plaintiff] Chasins' decision to buy the stock" (438 F. 2d at 1171). In affirmatively resolving this issue, the Court stated:

"Knowledge of the additional fact of market making by Smith, Barney in the three securities recommended could well influence the decision of a client in Chasins' position, depending on the broker-dealer's undertaking to analyze and advise, whether to follow its recommendation to buy the securities; disclosure of the fact would indicate the possibility of adverse interests which might be reflected in Smith, Barney's recommendations. Smith, Barney could well be caught in either a 'short' position or a 'long' position in a security, because of erroneous judgment of supply and demand at given levels. If over-supplied, it may be to the interest of a market maker to attempt to unload the securities on his retail clients. Here, Smith, Barney's strong recommendations of the three securities Chasins purchased could have been motivated by its own market position rather than the intrinsic desirability of the securities for Chasins. An investor who is at least informed of the possibility of such adverse interests, due to his broker's market making in the securities recommended, can question the reasons

* See also Straub v. Vaisman and Company, Inc., (CCH) Fed. Sec. L. Rep. ¶95,623 (3rd Cir. 1976).

for the recommendations. The investor, such as Chasins, must be permitted to evaluate overlapping motivations through appropriate disclosures, especially where one motivation is economic self-interest. See SEC v. Capital Gains Research Bureau, Inc. 375 U.S. 180 at 196, 84 S. Ct. 275, 11 L. Ed. 2d 237 (1963)." 438 F. 2d at 1172.

The Chasins holding that an investor who purchases a security from an interested principal "must be permitted to evaluate overlapping motivations through appropriate disclosures, especially where one motivation is economic self-interest" applies with at least equal force* to the FOUNDATION which relied on GS' recommendation to purchase PENN CENTRAL commercial paper and GS' judgment of the creditworthiness of PENN CENTRAL without knowing that GS had stopped carrying the paper on an inventory-risk basis and would only continue to sell it on a tap issue, no-risk basis. Pursuant to the holding in Chasins, it is therefore clear that GS' judgment and recommendation with respect to PENN CENTRAL and its continuing sale of PENN CENTRAL commercial paper "could have been" affected by GS' decision to sell the PENN CENTRAL commercial paper only on a non-inventory no-risk basis and that disclosure of the fact should have been made to the FOUNDATION.

Similarly, in Dale v. Rosenfeld, supra, this Court held that the failure of an underwriter to disclose that it did not have a "firm commitment" to purchase unsold shares, as opposed to a "best efforts arrangement" to sell the shares, was a violation of §12(2). GS' decision to change from selling PENN CENTRAL

* Indeed, the facts in the instant case are stronger than those in Chasins. In Chasins the seller failed to disclose that it was making a market in the stocks it sold. Here, GS failed to disclose that it had recently decided it would no longer purchase the PENN CENTRAL paper it had been selling on a risk basis.

commercial paper on an inventory-risk basis to a tap issue, no-risk basis parallels the difference between "firm commitment" and "best efforts" underwritings. Accordingly, GS' failure to disclose to the FOUNDATION the change in its selling policy with respect to PENN CENTRAL commercial paper also violated §12(2).

Thus, the District Court's ruling that because the FOUNDATION relied on GS' judgment as to creditworthiness, GS had no duty to disclose the inventory omissions "unless the omitted facts, of themselves, rendered a judgment that the company was creditworthy unreasonable" was clearly erroneous. In that connection, the District Court's finding that the \$10,000,000 repurchase (and inventory limitation) was "not the result of ... sinister machinations, but rather of honest business considerations ..." (422 F. Supp. at 893), is not only contrary to the evidence but, in any event, is irrelevant. In contrast to the "honest business considerations" espoused by GS for the repurchase and inventory limitation is the fact that:

(a) PENN CENTRAL was the only issuer, financial or industrial, required by GS to repurchase and to be subject to an inventory limitation, notwithstanding alleged "negative carry" and "markup" losses with respect to other issuers.

(b) The repurchase and inventory limitation occurred within six (6) days of the announcement of PENN CENTRAL'S 1969 financial losses.

(c) The inventory limitation would only continue until PENN CENTRAL obtained long-term financing, 100% bankline coverage and decreased its operating losses [PX-14,1722a], i.e. until PENN CENTRAL was no longer a risk to GS. The limitation, therefore, could not have been the result of a

uniform policy by GS to change to a tap-issue, special order method for selling commercial paper since the "policy" was to be eliminated as soon as PENN CENTRAL became less of a risk to GS.

(d) GUSTAVE LEVY ethically or legally* could not have utilized his inside knowledge of the precarious financial condition of PENN CENTRAL to safeguard the Annenburg Trust portfolio.

Moreover, even assuming that sufficient evidence existed to support the District Court's finding of "honest business considerations", such a finding does not detract from the obvious fact that a reasonable investor would nonetheless consider the inventory omissions important. See Herzfeld v. Laventhol, Krekstein, Horwath and Horwath, 540 F. 2d 27 (2d Cir. 1976).

2. THE BANK LINES OMISSION

From February 1969, until it stopped selling PENN CENTRAL commercial paper in Spring 1970, GS sought without success to have PENN CENTRAL increase the bank line coverage for its commercial paper from 50% [Tr. 582, 582a] to 100%**. The history of GS' futile efforts to have PENN CENTRAL increase the bank line coverage for its commercial paper from 50% to 100% is documented by the following Blue Sheets:

(a) PX-21 [1724a] dated February 27, 1969:

"After consultation with J. H. Rhoades and M. L. Evans, I advised Bill Gerstnecker, VP Corporate, that their plan for the increase

*SEC v. Texas Gulf Sulphur Co., supra.

**LEVY testified that the following were the "primary problems" GS had with PENN CENTRAL: "...we wanted them to get 100 per cent bank-line coverage and we only had 50 per cent and the problem was the paper was not moving very fast." [Levy Deposition 140, 1192a].

by \$50MM in c/p outstandings (to \$150MM) did not require the Penn Central to increase their lines of credit due to the temporary nature of the program and their access to credit. If they determined subsequently to hold at or near the upper limit, I told Bill we felt they should increase lines by \$25-\$50MM. ..."

PIETER FISHER, the corporate finance new businessman assigned to the PENN CENTRAL account and the author of PX-21, was not asked to explain why he recommended that in February, 1969, a non-temporary increase in PENN CENTRAL'S outstanding commercial paper should be accompanied by an increase in PENN CENTRAL'S banklines*. This Blue Sheet appears to reflect the first occasion on which GS was notified that PENN CENTRAL intended to increase its original \$100,000,000 of outstanding commercial paper. Prior to this increase, PENN CENTRAL had 100% bankline coverage for its commercial paper.

(b) PX-20 [1723a], a Blue Sheet by VOGEL dated September 19, 1969, reporting on a September 11, 1969 meeting between PENN CENTRAL and GS:

"RGWilson discussed the nuances of the current commercial paper market, particularly the stronger emphasis on bank line coverage in the minds of investors. He asked if it were possible for Penn Central to get an additional \$50MM in lines and John said it was but he said he would prefer not to do so. The outside lines presently in force could be used on a demand basis which of course will add to the company's flexibility.

*GS cannot now explain this requested increase in banklines by arguing that in times of tight money investors wanted commercial paper with more banklines [e.g., Tr. 325,325a; Tr. 386,386a] because VAN CLEAVE and WILSON testified that the "tight money period started" about September, 1969 [Tr. 386,386a; Tr. 867,867a; Tr. 870,870a]. Similarly WILSON testified that in November and December, 1969, investors were becoming nervous and he "thought that the way to offset some of that nervousness by certain of these investors was to get more banklines..." [Tr. 867,867a].

* * *

John feels that all of these factors should be considered in lieu of increasing banklines. RGWilson said that we would for the time being not insist on such increase and would report back to him on any market resistance the Penn Central notes received because of the 50% coverage factor." (emphasis supplied).

This Blue Sheet appears to reflect the first occasion on which GS was notified that PENN CENTRAL intended to increase its outstanding commercial paper from \$150,000,000 to \$200,000,000. Again, upon learning of a proposed increase in the amount of PENN CENTRAL'S outstanding commercial paper, GS requested, but did not "for the time being insist" on, a commensurate "increase" in supporting banklines.

(c) PX-28 [1726a], a Blue Sheet dated November 10, 1969 from WILSON with copies to LEVY and FISHER:

"In talking with John O'Herron, Vice President, this morning about how fast we could put out the additional \$50MM Penn Central paper, I told him that the recent article in the New York Times financial page quoting their counsel, Mr. Cox, to the effect that Penn Central was having a very rough time with the merger, could be very harmful to the sale of their commercial paper. I advised him that they may want to be thinking about getting another \$50MM of standby lines."

(d) PX-22 [1725a], a Blue Sheet dated December 9, 1969 by VAN CLEAVE with copies to "RGW LWD PAF JAV RML":

"The purpose of the meeting was to discuss the overall commercial paper and bank borrowing program for the company. The company has a revolving credit of \$300MM of which they owe \$250MM, \$50MM in straight lines of credit of which they are owing zero. Total commercial paper outstanding is \$200MM which gives them 50% line coverage.

* * *

JAVogel brought up the subject of line coverage pointing out that there are now investors that will not buy c/p unless there is 100% coverage, and that although we do not feel 100% coverage is necessary, questions are being asked in this regard." (emphasis supplied)*.

(e) PX-11 [1717a], a "CONFIDENTIAL" Blue Sheet dated February 5, 1970 by WILSON:

"I told him [O'HERRON] it was our judgment that this news will have an adverse effect on their sale of c/p and we may not be able to keep out \$200MM of their notes. I said the most important thing they could do is get another \$100MM in standby lines to back up their c/p and that some of these lines should be swing lines or demand lines. He said he did not think that with the banks as tight as they are, they could get \$100MM in standby lines.

* * *

To summarize our position, Penn Central is on notice that we feel the earnings report will have an adverse effect on the sale of their paper and they may not be able to keep out \$200MM. We have asked them to set up \$100MM in new lines so that they will have 100% line coverage." (emphasis supplied).

(f) PX-12 [1719a], a Blue Sheet dated February 6, 1970 by WILSON relating to a luncheon meeting on that day:

"We [LEVY and WILSON] then got into a discussion of c/p and we told them [O'HERRON, BEVAN, LODER of PENN CENTRAL] that if they didn't get the \$100MM more in lines to bring them up to 100% line coverage, we thought their present level of \$200MM would run down by \$50MM-\$100MM." (emphasis supplied).

*The District Court found that:

"Throughout this month [December] Wilson pressed O'Herron to increase the banklines, informing him of market resistance to the notes in view of the continued negative financial news." 422 F. Supp. at 899.

(g) PX-14 [1722a], a Blue Sheet dated March 23, 1970

by WILSON:

"I talked at length with John O'Herron, Vice President, today. With some reluctance he told me the first quarter's figures will look terrible. The railroad will show an operating loss which they may or may not offset with profits from the sale of certain assets. He then told me of the \$50MM backup lines for c/p \$17MM have been converted to demand lines. Regarding their obtaining 100MM of Eurodollar backup lines for c/p, he said he has on his desk Ray Lepley's memorandum. John said he didn't think it was complete enough and was not prepared to take any action at this time. I emphasized how important it is for them to get more lines as some investors are being more selective in their buying of notes and wanted full line coverage.

* * *

I told him that was not my understanding and that, in fact, GS&Co. felt that a \$5MM ceiling was appropriate until such time as they obtained 100% line coverage, completed some of these long-term financings, and started to reduce the operating losses." (emphasis supplied).

Throughout this same period of time, GS encouraged its other commercial paper issuers to have 100% bankline coverage [Tr. 783, 783a] and most did. Thus, the only commercial paper issuers not having 100% bankline coverage during this period other than PENN CENTRAL (that WILSON could recall) were "some of the AT&T subsidiaries..." [Tr. 870, 870a] and LEPLEY testified (in connection with the December 9, 1969 meeting between GS and PENN CENTRAL [PX-22, 1725a]) as follows:

"Q. Did he [VAN CLEAVE] say that it was customary for companies to have either eighty percent or one hundred percent line coverage?

A. I don't remember eighty percent, but I remember him saying it was customary for many of the customers to have one

hundred percent back-up, and as I remember, I pursued that a little further with him and he said on some of them, perhaps they would have something less than one hundred percent, but the majority of their customers, he indicated had one hundred percent." [Lepley Deposition 46,1188a].

"Q. Do you recall anything that you said at the meeting of December 9?

A. I inquired a little bit more deeply on the number of customers that they might have that had one hundred percent back-up.

Q. Can you recall why you did so?

A. I wanted to make sure when we got to the office, that we could report that indeed we were more or less, sticking out like a sore thumb among Goldman Sachs customers not having a high percentage of back-up.

Q. Did you reach just that conclusion after the meeting of December 9?

A. I would say I was pretty well convinced."
[Lepley Deposition 49-50,1189a] (emphasis supplied).

Not only did GS continually urge PENN CENTRAL to obtain the 100% bankline coverage possessed by its other issuers, but during this period of time "more and more" of GS' sophisticated and professional investors* only wanted commercial paper of issuers with 100% bankline coverage [Tr. 514, 514a]. Therefore:

(a) At the September 9, 1969 meeting between PENN CENTRAL and GS:

"RGWilson discussed the nuances of the current commercial paper market, particularly the

* VAN CLEAVE testified that commercial paper "is strictly a sophisticated investor's market...." [Tr. 237, 237a ; Tr. 361, 361a]. LEVY testified that approximately 90% of GS' customers for commercial paper were "professional investors". [Tr. 780, 780a]. In Mallinckrodt Chemical Works v. Goldman, Sachs & Co., 420 F. Supp. 231 (S.D.N.Y. 1976), Judge Tenney found that the typical customer for commercial paper is sophisticated and a corporation with personnel trained for the investment of surplus corporate funds.

stronger emphasis on bankline coverage in the minds of investors." [PX-20,1723a].

With respect to the same meeting, WILSON testified that he told

O'HERRON:

"...that the market at that time was becoming tighter. 'Tighter' to me means interest rates were continuing to rise, that investors, some investors were looking for fuller line coverage, close to 100 percent. Even for some of the very largest issuers of paper." [Wilson Deposition 50,1222a].

(b) At the December 9, 1969 meeting between GS and PENN

CENTRAL:

"JAVogel brought up the subject of line coverage pointing out that there are now investors that will not buy c/p unless there is 100% coverage..." [PX-22,1725a].

LEPLEY testified that at this meeting he was advised by GS that GS wanted PENN CENTRAL to have 100% bankline coverage to "facilitate the sale of our commercial paper" and because "investors in general looked for commercial paper that had a one hundred percent back-up" [Lepley Deposition 26,1184a].

(c) With respect to the February 6, 1970 meeting [PX-12,1719a], BEVAN testified:

"Q. Do you have any recollection of having discussed with any representative of Goldman Sachs, whether it was on February 6 or sometime in early 1970, the possibility of increasing the bank line coverage

A. Yes.

Q. ---- on the commercial paper?

A. Yes. I can't tell you whether it came to me directly from them or whether by way of John O'Herron.

But they thought as a precaution, being conservative, that we could -- and they also said that they had some buyers who had a rule that they would only do -- buy any of your commercial paper where there was a hundred per

cent coverage, so they thought that would improve our market and that this was the conservative thing to do." [Bevan Deposition 46-47, 1133a].

(d) In a telephone conversation on March 23, 1970 with O'HERRON, WILSON "emphasized how important it is for them [PENN CENTRAL] to get more lines as some investors were being more selective in their buying of notes and wanted full line coverage " [PX-14, 1722a].

(e) LEVY, WILSON, VOGEL, ANCZARKI, HANSELL, HARRE, STUTT, TOLAN and BRENKART* each testified that investors were concerned with and desired greater bankline coverage than PENN CENTRAL possessed.

(f) The District Court found that to "many investors at the time 100% coverage was an important index of creditworthiness..." 422 F. Supp. at 896.

In addition to the fact that investors in general considered the extent of an issuer's bankline coverage to be important, supra, this was an area of great concern to GS with regard to PENN CENTRAL. Not only did GS continually request PENN CENTRAL to increase its bankline coverage, supra, but LEVY and WILSON told BEVAN, O'HERRON and LODER of PENN CENTRAL at the February 6, 1970 luncheon:

"...that if they didn't get the \$100MM more in lines to bring them up to 100% line coverage, we thought their present level of \$200MM would run down by \$50MM-100MM" [PX-12, 1719a].

In other words, GS believed that the existence of 100% bankline

* Respectively, [Levy Deposition 186, 190; 1194a]; [Wilson Deposition 50, 121; 1222a]; [Vogel Deposition 130, 152; 1213a; [Anczarki Deposition 20; 1130a]; [Hansell Deposition 7, 23; 1167 a]; [Harre Deposition 50, 1175a]; [Stutt Deposition 37, 1202a]; [Tolan Deposition 31, 1210a]; [Brenkart Deposition 9, 1147a].

coverage would influence the investment decisions of commercial paper buyers with respect to PENN CENTRAL commercial paper purchases to the extent of \$50,000,000 to \$100,000,000. Similarly, on March 23, 1970, WILSON told O'HERRON that the \$5,000,000 inventory limitation would not be removed "until", among other things, "they obtained 100% line coverage..." [PX-14,1722a]. In connection with GS' concern over insufficient banklines (as manifested by GS linking the \$5,000,000 inventory limitation to PENN CENTRAL'S obtaining 100% bankline coverage) and its continued efforts to have PENN CENTRAL increase its bankline coverage, the following language from SEC v. Shapiro, supra, is again instructive:

"Finally, and most convincingly, defendants' own conduct illustrates the materiality of the information. A major fact in determining whether events are material is the importance attached to them by those who knew about them." 349 F. Supp. at 54.

Based on the foregoing uncontroverted evidence, it must be concluded that the failure of GS to disclose that PENN CENTRAL would (or could) not obtain 100% bankline coverage despite the repeated urgings of GS was a material omission. These fact(s) would clearly have "assumed" actual significance in the deliberations of a "reasonable shareholder" or would be facts to which "a reasonable[*]

* Although GS' witnesses characterized the desire of its sophisticated and professional commercial paper investors for 100% bankline coverage as "arbitrary" and laziness on the part of its investors who were merely seeking a "credit short cut" or "crutch" [Tr. 511,511a;Tr. 514,514a;Tr. 867,867a;Tr. 949,949a], GS never told any one of the increasingly large number of investors who wanted commercial paper with 100% banklines that banklines have nothing to do with safety or that they were being lazy or arbitrary in seeking paper with 100% bankline coverage. Instead, GS listened to its investors' demands for commercial paper with 100% bankline

(Footnote continued on next page)

man would attach importance in determining his choice of action in the transaction in question". Thus, LEMAY testified that he would not have "shown" PENN CENTRAL commercial paper to the FOUNDATION had he been aware of the banklines situation [Tr. 32, 32a]. In any event, the reliance so many (sophisticated and professional and therefore reasonable) investors placed on 100% bankline coverage is sufficient alone to satisfy the test for materiality of the omissions by GS. TSC Industries, Inc. v. Northway, Inc., supra. Finally, the disclosure of GS' requests for, and PENN CENTRAL'S inability to obtain, increased bankline coverage was necessary to make GS' recommendation of the paper and its representations that PENN CENTRAL was creditworthy and that an adequate credit investigation had been conducted not misleading because, as the District Court held*, the inability to obtain banklines** is "relevant to a judgment of creditworthiness", even though it may not "be necessarily conclusive of the judgment." 422 F. Supp. at 896. See Herzfeld v. Laventhol, Krekstein, Horwath and Horwath,

(Footnote cont'd.)

coverage and told PENN CENTRAL to increase its banklines so that it could sell more paper to these investors. Thus, WILSON testified: "...rather than lose accounts that were buying Penn Central I wanted to make sure we held on to all the ones that we had and maybe even add more to it. So that was my reasoning behind recommending to them that they get more banklines." [Tr. 867,867a].

* The District Court found that, "...a credit analysis to assure that the Company was creditworthy...requires examination of a company's access to cash in the near future either through anticipated earnings, lines of bank credit, anticipated long-term financing or assets which can be readily pledged or sold." 422 F. Supp. at 887 (citations to the transcript omitted).

**Although VOGEL could not directly answer a question as to whether "in making a judgment as to creditworthiness of an issuer, banklines are important" he did admit that, "If it is not creditworthy, they won't get banklines..." [Tr. 66,66a]. Despite the foregoing, when PENN CENTRAL on February 6, 1970, told WILSON it did not feel it could obtain additional banklines [PX-12,1719a] WILSON testified he did not believe it [Tr. 894,894a]. Of course GS never asked PENN CENTRAL whether it had been denied any banklines. [Tr. 994,994a].

supra. The "connection" between the banklines with respect to the commercial paper of an issuer and the issuer's creditworthiness is demonstrated by the following evidence:

(a) Of the \$100,000,000 in banklines supporting PENN CENTRAL'S commercial paper, \$96,000,000 were actually used in the Spring of 1970 by PENN CENTRAL [Lepley Deposition 32,1186a; Sullivan Franklin (DC) Tr. 878-879, 1114a].

(b) PENN CENTRAL regarded banklines as being the equivalent of assets which could be liquidated to pay commercial paper indebtedness as indicated in its application dated September 11, 1969 to the ICC to increase the amount of outstanding commercial paper to \$200,000,000, wherein it is stated [PX-68 at 9 ,1753a]:

"Assuming the issuance of the commercial paper described in this Application, Applicant will have outstanding \$200,000,000 of commercial paper backed up by loan commitments of banks in the amount of \$100,000,000. Such loan commitments provide reasonable assurance that Applicant will be able to meet such of its commercial paper maturities as it may not be able to refund by new issues of commercial paper or by issuance of other securities or pay out of cash in its treasury."

On October 1, 1969, PENN CENTRAL advised the ICC that:

"Bank lines of credit for \$100 million have been exclusively committed to refund maturing commercial paper notes of Penn Central Transportation Company if at any time market conditions prevent the sale of commercial paper notes to meet maturities of such notes. In addition, Penn Central Transportation Company and its subsidiaries have assets which can be liquidated to cover maturing commercial paper notes." [PX-67, 1739a].

(c) In its financial statements, PENN CENTRAL carried the amount of its commercial paper which was backed by banklines as long-term debt after one year [PX-39 at 2,1731a].

Accordingly, the failure of GS to disclose the foregoing facts relating to the banklines to the FOUNDATION in connection with its purchase of PENN CENTRAL commercial paper constituted a violation of §12(2) of the 1933 Act. Indeed, GS' failure to disclose its financial interest in having PENN CENTRAL obtain more banklines (e.g., enabling GS to retain its existing investors in PENN CENTRAL and to obtain more investors [Tr. 867,867a]) and the fact that increased banklines would decrease the risk of loss to GS was itself a violation of §12(2). Chasins v. Smith, Barney & Co., supra, and Dale v. Rosenfeld, supra.

3. THE BROWN BROS. HARRIMAN & CO. OMISSION

On February 4, 1970, PENN CENTRAL announced that it lost \$56,000,000 in 1969 of which \$16,000,000 was attributable to losses in the fourth quarter. BROWN BROS. HARRIMAN & CO. ("BROWN BROS.") had held approximately \$30,000,000 in PENN CENTRAL commercial paper or 15% of PENN CENTRAL'S \$200,000,000 outstandings. [PX-12,1719a]. BROWN BROS. was, and is, a "highly respected banking institution" (422 F. Supp. at 903) and an investment banker having substantial experience in connection with railroads [Tr. 829-830, 829a ; Wilson Deposition 640,1224a; Weinberg Deposition 128,1218a]. BROWN BROS. had a long standing banking relationship with PENN CENTRAL and had extended PENN CENTRAL a \$2,000,000 line of credit in August 1968 [PX-34,1728a; DX-BY,1889a]. On February 5, 1970, GS learned that BROWN BROS. had removed PENN CENTRAL from its approved list of commercial paper issuers. 422 F. Supp. at 890.* When the FOUNDATION purchased its PENN CENTRAL commercial

*BROWN BROS. action like GS' inventory reduction, eliminated a large source of cash for PENN CENTRAL at a time when it was dependent upon roll-overs to meet its maturing commercial paper obligations.

paper from GS, GS did not disclose that BROWN BROS. had taken this action.

The record clearly establishes that the BROWN BROS. omission was material. LEMAY testified that he was unaware of the removal of PENN CENTRAL from BROWN BROS. list of approved issuers and that he would not have advised the FOUNDATION that PENN CENTRAL commercial paper was available had he been so aware [Tr. 30-32, 30a]. Moreover, it is submitted that any reasonable investor would consider it significant and important that an investment banker with expertise in railroads who had owned \$30,000,000 of PENN CENTRAL commercial paper had decided to discontinue purchasing the same. The importance of BROWN BROS. action is not diminished by its prior extension of a \$2,000,000 line of credit to PENN CENTRAL which was utilized in Spring 1970. There is no evidence that the line of credit extended by BROWN BROS. was not a confirmed line in which case it could not have been withdrawn by BROWN BROS. In any event, by its action, BROWN BROS. perpetuated its reputation as a reliable source for banklines of credit and in effect insured that its losses would be limited to \$2,000,000, instead of being exposed to a \$30,000,000 risk that PENN CENTRAL would be unable to pay its commercial paper when it matured.

Furthermore, the disclosure of BROWN BROS. removal of PENN CENTRAL from its list of approved issuers was necessary to make GS' recommendation of PENN CENTRAL commercial paper and its representations that PENN CENTRAL was creditworthy and that an adequate credit investigation of PENN CENTRAL had been conducted by GS not misleading. As the District Court held, BROWN BROS. conduct was "relevant" to a "judgment" of "creditworthiness". 422 F. Supp. at 896. Indeed, GS virtually did not even try to find

out why BROWN BROS. removed PENN CENTRAL from its approved list [Tr. 956-957, 956a] despite the fact that this information was available to GS* [Tr. 381,381a] and PENN CENTRAL, obviously concerned, had requested that GS arrange a meeting between PENN CENTRAL and BROWN BROS. [PX-12,1719a].

POINT V

THE DISTRICT COURT ERRED IN CONCLUDING THAT NCO'S PRIME RATING OF PENN CENTRAL COMMERCIAL PAPER WAS NOT BASED ON GS' DECISION TO CONTINUE SELLING THE PAPER

The District Court held that GS represented to the FOUNDATION that PENN CENTRAL commercial paper was rated "Prime" by NCO (422 F. Supp. at 893) and that if GS was informed that NCO'S rating was based "solely" upon GS' decision to continue to sell the paper, "...a failure to qualify the representation that the paper was NCO Prime...would clearly constitute a material omission 'necessary in light of the circumstances'". 422 F. Supp. at 895.

The District Court, however, found that the:

"...preponderance of the credible evidence does not support the Foundation's claim that the 'Prime' rating was based exclusively on the defendant's decision to continue sales or that GS had reason to believe that this was the case". 422 F. Supp. at 897.

It is submitted that this conclusion is not supported by the record.

The GS Blue Sheets dated February 5, 1970 [PX-10,1716a] and

* GS' failure to ascertain why BROWN BROS. removed PENN CENTRAL from its approved list is consistent with its failure to find out whether PENN CENTRAL had been denied banklines. Its argument (GS Brief, pp. 51-52) that had it "asked for Brown Brothers' view" the "reasonable inference" is that Brown Brothers "thought Penn Central creditworthy" is contradicted by the evidence. More importantly, the argument ignores the District Court's holding: "The main point, however, is not what Goldman, Sachs would have learned but what it should have done to discharge its duty reasonably to inquire" 422 F. Supp. at 904.

February 6, 1970 [PX-12,1719a] establish beyond a peradventure of doubt that NCO'S "Prime" rating of PENN CENTRAL commercial paper was predicated solely on VOGEL'S statement to ROGERS that GS would continue to sell the paper. Consequently, the District Court's conclusion, based upon its (unreasonable) interpretation of PX-10 and PX-12, was clearly erroneous.

PX-10 is a Blue Sheet written by VOGEL on February 5, 1970 which memorializes his telephone conversation with ROGERS of NCO on that date. The importance of the VOGEL-ROGERS conversation and PX-10 is demonstrated by the fact that although VOGEL had "frequent" telephone conversations with ROGERS about many issuers (including PENN CENTRAL [Tr. 530-531,530a ; Tr. 639-640, 639a]), VOGEL reduced only the February 5, 1970 conversation to writing [Tr. 639-640, 639a]. PX-10 provides:

"February 5, 1970

Alan Rogers of NCO called me today to express concern over the sharply reduced earnings announced in the newspapers today. He asked if we were continuing to sell the Company's notes and whether I felt that Penn Central had sufficient resources which could be converted to cash to pay down debt if necessary. I said that Goldman, Sachs was continuing to sell the commercial paper notes of Penn Central Transportation Company. In answer to question number 2, I suggested that the Company has a number of valuable properties and securities, and that I was certain that something could be worked out should it ever become necessary.

Alan said that as a result of my comments, he would continue to carry Penn Central Transportation Company as a prime name.

JACK A. VOGEL

cc: GLL, JCH, JLW, RGW, GVC, LED, PAF"
(emphasis supplied).

The clear import of PX-10 is that NCO would continue to rate PENN CENTRAL commercial paper prime because GS "was continuing to sell the commercial paper" of PENN CENTRAL (or, conversely, but for GS continuing to sell the paper, NCO would not continue to rate it as prime).

Erroneously disregarding the plain meaning of PX-10, the District Court stated:

"In the absence of additional evidence to support the inference the Foundation would have us draw, we are unwilling to read Rogers' casual remark to his friend Vogel that 'as a result of my comments... he would continue to carry [the Company] as a prime name' with the literalness which might be accorded to an affidavit. The reasonable interpretation is that, in combination with everything else he knew about the Company, Vogel's continued belief in the Company's viability was sufficient and credible reassurance to Rogers that the paper was entitled to a 'Prime' rating." 422 F. Supp. at 897.*

* The District Court further stated:

"As we read Vogel's blue sheet of February 5th, it is not the damning document the Foundation claims it to be. In fact, it is not unreasonable to infer that had Lemay been shown a copy of this memo, he would have viewed it as an added assurance of the safety of the investment." 422 F. Supp. at 897.

The Court's speculation as to the anticipated behavior of LEMAY had he seen PX-10 overlooks the testimony that LEMAY would not have informed the FOUNDATION of the availability of the PENN CENTRAL commercial paper had he been aware that NCO had "advised" GS it would continue its prime rating of the paper if GS continued to sell it [Tr. 39-40, 39a].

At 422 F. Supp. 903 the Court added, "it is of course true that Vogel satisfied Rogers that the Company remained creditworthy...". Not only is there no evidence to support the District Court's conclusion that, in continuing to rate PENN CENTRAL commercial paper as prime, ROGERS or NCO relied on anything other than VOGEL'S statement that GS would continue selling the paper but, in addition, such a conclusion is contradicted by the following facts and circumstances:

(a) The plain meaning of PX-10 which VOGEL testified was complete and accurate [Tr. 540, 540a]. As the District Court recognized (422 F. Supp. at 897), the "literal" interpretation or plain meaning of PX-10 is that NCO would continue to rate PENN CENTRAL commercial paper prime as a result of the fact that GS would continue to sell the paper and that GS believed PENN CENTRAL was creditworthy. Moreover, the self-serving and contradictory interpretation of PX-10 by VOGEL (objected to by the FOUNDATION [Tr. 541, 541a]) is simply not believable*. Thus, after the following testimony of VOGEL with respect to PX-10:

* In any event, the oral testimony of VOGEL which conflicts with PX-10 (and PX-12) should be given little weight:

"We think that United States v. Yellow Cab Co., 338 U.S. 338, 70 S. Ct. 177, did not modify what was said in the Gypsum case. In Gypsum, an antitrust action, the defendants testified orally that they had not acted in concert, and the trial judge so found. The Supreme Court rejected that finding, remarking that 'the witnesses denied that they***had agreed to do the things which in fact were done. Where such testimony is in conflict with the contemporaneous documents we can give it little weight,***. In Yellow Cab, where the Court affirmed the trial judge's findings against the government in an antitrust action, the oral testimony was not incompatible with inferences which could reasonably be drawn from the documentary evidence.'" (footnote omitted). Orvis v. Higgins, 180 F. 2d 537, 539 (2d Cir. 1950).

"I intended to convey the fact that as a result of Goldman Sachs' continuing to market commercial paper of the Penn Central that Alan Rogers, or NCO would have to, have to continue to either rate it or pull its rather [sic], whatever their choice may be at the time. That's what I intended to convey. ...

The fact that we were handling the paper made it imperative that they continue their own investigation" [Tr. 541-542, 541a],

the District Court commented:

"Well, that isn't what you said here, though. You said -- if you read the last sentence, you say, 'that as a result, you are continuing to carry Penn Central as a prime name'." [Tr. 542, 542a].

(b) The plain meaning of PX-12, a Blue Sheet prepared by WILSON to record the events at the February 6, 1970 PENN CENTRAL-GS luncheon which WILSON testified was "complete and accurate" [Tr. 991, 991a]. At this luncheon (which VOGEL did not attend) WILSON found VOGEL'S February 5, 1970 telephone conversation with ROGERS of sufficient importance to repeat to PENN CENTRAL. Thus, PX-12 provides:

"I also explained Allen Rogers' conversation with Jack Vogel and Allen's feeling that as long as Goldman, Sachs was going to continue to handle Penn Central's c/p he would keep the Prime rating."*

*The District Court found "differences" between PX-10 and PX-12 but attempted to reconcile these differences by attributing "greater weight" to VOGEL'S "formulation" and by speculating that WILSON had a legitimate business motive to convince PENN CENTRAL that GS had "a particularly strong input into the rating decision" by NCO of PENN CENTRAL'S commercial paper. 422 F. Supp. at 897.

(c) The Securities and Exchange Commission Staff Report to the Special House Subcommittee on Investigations entitled "The Financial Collapse Of The Penn Central Company" [PX-113 for identification, 1801a] (hereinafter the "SEC Staff Report") which the District Court erroneously did not admit into evidence* concluded that:

"As a result of this conversation with Rogers, Goldman, Sachs became aware of facts which undermined the value of the prime rating given by NCO to the company's paper and the independent nature of that determination. Thus, from this point on it appears that NCO was not the thorough, independent rating service that Goldman, Sachs had represented to customers that it was. In addition, from this point on, Goldman, Sachs was aware that the 'prime' rating was based to a great extent on the fact that Goldman, Sachs was continuing to offer it. They also believed that the 'prime' rating was based in part on Vogel's opinion that the company had sufficient properties and valuables -- which fact Goldman, Sachs had never investigated -- to liquidate if necessary. Furthermore, if they were looking to liquidation as a means of determining creditworthiness, the railroad clearly was no candidate for the 'prime' rating." [PX-113 at 283-284, 1814a].

(d) The conclusion of Judge Metzner in Franklin (DC) at 44, based upon his reading of PX-10:

"The only trouble with Goldman Sachs' position is that the rating organization (NCO) appears to have continued the prime rating on February 5 in reliance on defendants' decision to continue to sell this paper despite adverse news as to the financial condition of Penn Central."

* The SEC Staff Report should have been admitted into evidence as a public record pursuant to the hearsay exception of Fed. R. Evid. 803(8). The Report was compiled by the SEC after an exhaustive investigation, involving 200 witnesses and thousands of exhibits, pursuant to §21(a) of the 1934 Act.

(e) In the pretrial order GS designated two employees of NCO as witnesses but did not call them at trial. Accordingly, it must be presumed that had they been called, their testimony would have been unfavorable to GS. Dow Chemical v. SS Giovannella D'Amico, 297 F. Supp. 699 (S.D.N.Y. 1969); Christman v. Maristella Compania Naviera, 349 F. Supp. 845 (S.D.N.Y. 1971), aff'd, 468 F. 2d 620 (2d Cir. 1972).

(f) The obvious ulterior motive and purpose of VOGEL and GS to have NCO retain its prime rating for PENN CENTRAL - without the rating, the sales of PENN CENTRAL commercial paper would cease before GS could resell its inventory to PENN CENTRAL, thereby imposing a risk of \$15,510,000 in unsold paper on GS.

Based upon the foregoing, it must be concluded that the District Court's determination (predicated on its unsupported and unreasonable interpretation of PX-10) that GS was not required to disclose that NCO'S prime rating was dependent upon GS continuing to sell PENN CENTRAL commercial paper was clearly erroneous.*

* "A finding is 'clearly erroneous' when although there is evidence sufficient to support it, the reviewing Court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." United States v. United States Gypsum Co., 333 U.S. 364, 395 (1948). Moreover, although the FOUNDATION has satisfied the foregoing standard, this standard does not even apply in the instant case because the primary evidence upon which the District Court based its interpretation was a document(s) which this Court is "in good a position as the trial judge to interpret..." Kind v. Clark, 161 F. 2d 36, 46 (2d Cir. 1947). See also Eddy v. Prudence Bonds Corp., 165 F. 2d 157, 163 (2d Cir. 1947), cert. den., 333 U.S. 845 (1948); Stamicarbon, N.V. v. American Cyanamid Co., 506 F. 2d 532, 537 (2d Cir. 1974) and cases cited therein; Agrashell, Inc. v. Bernard Sirotta Co., 344 F. 2d 583, 589 (2d Cir. 1965); Orvis v. Higgins, supra; Dale v. Rosenfeld, supra, (where this Court, reversing the determination of the trial court sitting without a jury, held that a prospectus was misleading) and United States Television, Inc. v. Fortnightly Corp., 377 F. 2d 872 (2d Cir. 1967) (and cases cited therein at n. 2) rev'd on other grounds, 392 U.S. 390, rehearing denied, 393 U.S. 902, (the

(Footnote continued on next page)

In addition to clearly misinterpreting PX-10, the District Court also misconstrued the contention of the FOUNDATION, and the applicable law, when it stated the FOUNDATION claimed that:

"The 'Prime' rating was based exclusively [or solely] on the defendant's decision to continue sales or that Goldman, Sachs had reason to believe that this was the case". 422 F. Supp. at 897 (emphasis supplied).

Although the FOUNDATION contends that the prime rating of NCO was exclusively based on GS' decision to continue to sell PENN CENTRAL commercial paper and such a conclusion is amply supported by the record, supra, it is merely sufficient that a reasonable commercial paper investor would attach importance to the fact, or it was significant, that the NCO rating was in any way based on a representation or decision by GS (as opposed to an independent determination being made by NCO) in order to impose a duty on GS to disclose such fact to the investor. Gerstle v. Gamble-Skogmo, 478 F. 2d 1281 (2d Cir. 1973); List v. Fashion Park, Inc., 340 F. 2d 457 (2d Cir. 1965), cert. denied, 382 U.S. 811 (1965); Katz v. Realty Equities Corp. of New York, 406 F. Supp. 802 (S.D.N.Y. 1976); Herzfeld v. Leventhol, Krekstein, Horwath and Horwath, supra. Exclusivity, though existent under the instant facts, is not required. Indeed, if, as the District Court held, it was material and GS should have disclosed that NCO'S rating was solely based on GS' decision, for the same reasons, the fact that the NCO rating was in part dependent on GS' decision should be equally material.

(Footnote cont'd.)

interpretation of a document constitutes a finding of law and, accordingly, the mandate of Rule 52(a) of the Federal Rules of Civil Procedure that findings "of fact shall not be set aside unless clearly erroneous" is inapplicable).

CONCLUSION

By reason of the foregoing, the decision of the District Court should be affirmed either on the basis set forth in the opinion or on the alternative grounds of the FOUNDATION discussed, supra.

Dated: May 16, 1977

Respectfully submitted,

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COURT OF APPEALS
SECOND CIRCUIT

UNIVERSITY HILL FOUNDATION,
Plaintiff-Appellee and Cross-Appellant,

- against -

GOLDMAN SACHS & CO.,
Defendant-Appellant & Cross-Appellee.

Appeal from the U.S. Dist. Court for the Southern
Dist. of N.Y.

Index No.

Affidavit of Personal Service

STATE OF NEW YORK, COUNTY OF

SS.:

I, Kevin E. Thomas, being duly sworn, depose and say that deponent is not a party to the action,
is over 18 years of age and resides at 1515 Macombs Road, Bronx, N.Y. 10452,

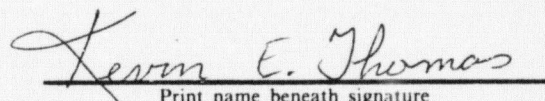
That on the 18th day of July 1977 at 48 Wall Street
New York, New York


deponent served the annexed

upon
Sullivan & Cromwell, Esqs.

the ~~Annexed~~ Brief in this action by delivering a true copy thereof to said individual
personally. Deponent knew the person so served to be the person mentioned and described in said
papers as the herein,

Sworn to before me, this 18th
day of July, k 19 77


Print name beneath signature
KEVIN E. THOMAS


ROBERT T. BRINN
Notary Public, State of New York
No. 31-0418950
Qualified in New York County
Commission Expires March 30, 1979